

ROADMAP TO ARIZONA'S ECONOMIC RECOVERY: A PACKAGE TO CREATE JOBS, IMPROVE THE STATE'S ECONOMIC COMPETITIVENESS, AND BALANCE THE BUDGET

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Dennis Hoffman, Ph.D.

Professor of Economics, University Economist,
and Director, L. William Seidman Research Institute

Tom R. Rex, MBA

Associate Director, Center for Competitiveness and Prosperity Research

Center for Competitiveness and Prosperity Research
L. William Seidman Research Institute
W. P. Carey School of Business
Arizona State University
Box 874011
Tempe, Arizona 85287-4011

(480) 965-5362

FAX: (480) 965-5458

EMAIL: Dennis.Hoffman@asu.edu or Tom.Rex@asu.edu

www.wpcarey.asu.edu/seid



EXECUTIVE SUMMARY

Arizonans face the twin problems of recovering from a deep and long economic recession and dealing with significant fiscal imbalances in state and local governments. This report addresses those two issues, with recommendations for both the near term and the long term.

Without intervention, the economy eventually will recover on its own. However, a recovery that takes years to complete is of little comfort to those currently unemployed, those working but earning less than they did before the recession, those who have lost their homes, those who no longer have health insurance, etc.

Moreover, if no action is taken to improve the state's economic competitiveness, the economic future of Arizona will be much like its recent past: The economy will follow a highly cyclical course that causes dislocations during every down cycle and will be marked by subpar job quality, inferior wages, low workforce participation rates, and below-average incomes.

In contrast to the natural recovery of the economy, the public sector's fiscal problems will not disappear on their own. While the cyclical portion of existing deficits will go away as the economy recovers, a large persistent deficit in the state's general fund, currently estimated at \$2.2 billion, will remain. The only solution to a persistent deficit is to permanently reduce spending and/or permanently increase revenues.

Given the state's low public spending even before the recession began, its substantial spending reductions during the last two years, and its long-term issues with respect to prosperity, an increase in revenues clearly is the preferred course of action and needs to be implemented as soon as possible. If this is not done, and if the spending reductions already implemented are not reversed within the next few years, the long-term economic health of the state will suffer.

Twenty years ago, Arizonans faced the same twin problems. Though the issues then were less severe than those facing the state today, Arizonans responded to the challenge in the late 1980s. The Arizona Strategic Planning for Economic Development effort brought Arizona's economic development strategies from 20 years behind their competitors to leading edge (though the tools that economic development agencies need to effectively compete never were adequately provided). The Fiscal 2000 effort took on the deficit that existed then, resolving it through a combination of spending reductions and revenue increases.

So far in this down cycle, little has occurred to address Arizona's problems. Despite the efforts and leadership of the Greater Phoenix Economic Council, no action has been taken to improve economic conditions. Similarly, efforts led by Governor Brewer to take on the state's fiscal problems have failed to gain traction in the Legislature. Despite the use of spending reductions and numerous one-time options, a large budget deficit remains in the state's general fund.

A roadmap to address both the short-term and long-term economic and fiscal issues is detailed in this report. If a plan like this is not adopted speedily, the short-term suffering of Arizonans will not be ameliorated, and the long-term outlook for the state will become unattractive.

The roadmap addresses economic needs by proposing actions in the near term to stimulate the economy and to provide jobs. Given the state's severe short-term fiscal limitations, these actions are limited to utilizing federal stimulus funds and to committing state funds obtained through long-term financing to improve the state's physical infrastructure. While many of the jobs created by infrastructure projects will benefit the beleaguered construction industry, the funding will ripple throughout the economy.

In the longer term, the economic focus of the plan shifts from job creation to job quality. In order to improve job quality, the state must build a stronger and broader economic base, which will require the state's economic competitiveness to be enhanced.

While improvements in competitiveness will produce benefits throughout the economy, the state needs to pay particular attention to the base industries that provide quality jobs and have the potential to lead economic growth well into the future. In order to attract and grow these key base industries, the roadmap concentrates on two methods to improve economic competitiveness. First, the quality of the workforce must be improved by strengthening the educational system and expanding job training programs. Second, the state needs to extend and improve the physical infrastructure, with transportation being especially significant.

A third way to improve competitiveness addressed in the roadmap is to become more competitive in business taxes, particularly those that affect the key basic industries. The plan incorporates the reduction of certain business taxes and the expansion of incentive programs. The ultimate goal of all of these economic actions is to improve the prosperity of all Arizonans.

The roadmap also addresses the state's fiscal difficulties in both the short and long term. With spending on public programs that are of significance to economic competitiveness already far below the national norm, and with the educational system, job training programs, and the physical infrastructure all being evaluated as in need of improvement, revenue enhancement is the primary solution to the fiscal problems, though in the short term growth in spending is restrained and the budget cuts of the last two years are not reversed.

The plan recommends a number of revenue enhancements to take effect at the beginning of the next fiscal year, when the state will face a \$2 billion deficit in addition to the spending reductions already implemented. While most of the proposals are recommended to be permanent changes to the revenue system, one key plank of the plan is a temporary three-year sales tax rate increase.

Even a \$2 billion increase in state revenues will not be enough to resolve its persistent deficit. Thus, additional revenue enhancements are proposed for fiscal year 2014. Though these additional funds could be used immediately, they have been postponed to avoid too-large a revenue increase in the near term while the economy is recovering and because some of the permanent changes to be made to the revenue system need to be further studied. The proposed changes to the revenue system in fiscal year 2014 include actions intended to bolster the state's economic competitiveness.

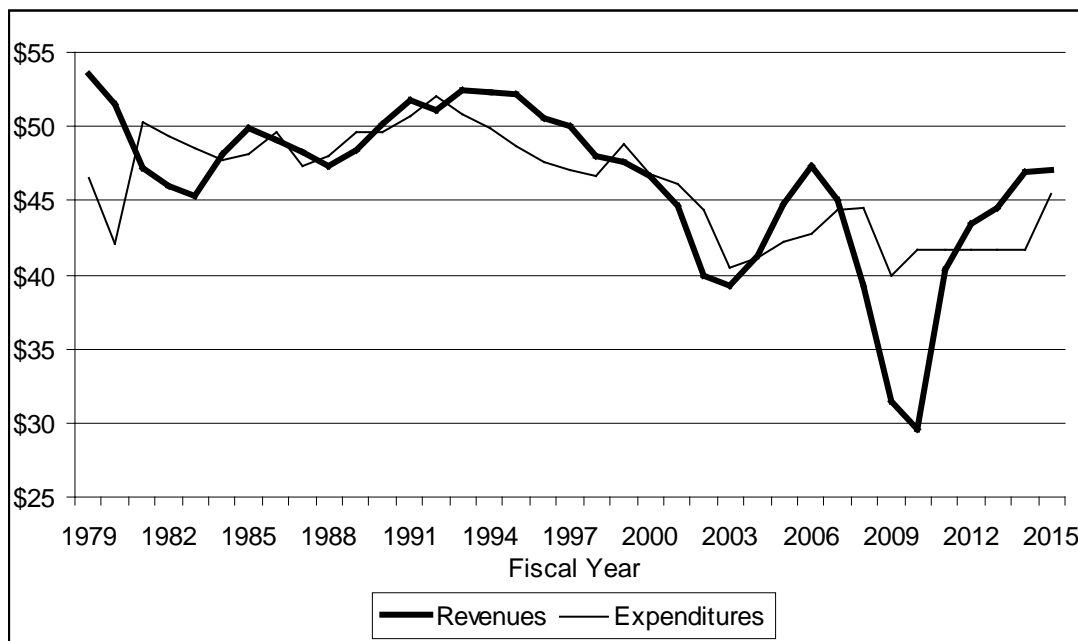
Nearly one-fourth of the total proposed increase in revenue, beginning in fiscal year 2014, will come from sources other than taxes. However, even if all of the additional revenue came in the

form of taxes, the state's tax burden would not be out of line with that in other states. Historically, Arizona's tax burden was among the middle of the states but it currently ranks among the bottom ten.

Under the proposed plan, general fund spending will be restrained for three-to-four years. During this period, the transfers of monies from other funds to the general fund made during the past two years need to be reversed. General fund spending then can be returned to the prerecessionary level and the budget stabilization fund can be rebuilt.

Even after reversing the spending reductions implemented during the past two years, the state's spending will remain below the historical norm, relative to the income of the state. Revenues also will be less than the historical average, as seen in the following chart.

ONGOING REVENUES AND EXPENDITURES PER \$1,000 OF PERSONAL INCOME, INCLUDING PROJECTIONS THROUGH FISCAL YEAR 2015, ARIZONA GENERAL FUND



Note: The fiscal year 2010 figures reflect projected revenues as of January 2010, appropriations adjusted for the reductions passed in the special sessions in fall 2009, and projected personal income.

Source: Arizona Joint Legislative Budget Committee (historical data) and Arizona State University, Office of the University Economist (projections).

TABLE OF CONTENTS

SUMMARY	5
BACKGROUND	14
Regional Economics	14
Public Sector	23
SCENARIO 1: INACTION	44
Job Creation: Nature and Timing of Economic Recovery in Arizona	44
Economic Competitiveness	44
State Budget: An Assessment of Current and Future Conditions Absent Any Action	46
SCENARIO 2: POSITIVE ACTION	50
Recommendations for Immediate Action	50
Recommendations for Longer-Term Actions	61
Year-by-Year Summary	70
Conclusion	73

LIST OF TABLES AND CHARTS

Tables:

1. Arizona General Fund, Fiscal Year 2010	33
2. A Qualitative Assessment of the Overall Revenue System as Currently Structured in Arizona	39
3. A Qualitative Assessment of the General Sales Tax in Arizona	40
4. A Qualitative Assessment of the Property Tax in Arizona	41
5. A Qualitative Assessment of the Personal Income Tax in Arizona	42
6. A Qualitative Assessment of the Corporate Income Tax in Arizona	42
7. Comparison of Budgets, Arizona General Fund	48
8. Recommended Increases in Revenue, Fiscal Year 2011, Arizona General Fund	55
9. Recommended Increases in Revenue, Fiscal Years 2011 Through 2014, Arizona General Fund	63
10. Projected Ongoing Revenues and Expenditures, Fiscal Years 2011 Through 2015, Arizona General Fund	71

Charts:

1. Ongoing Revenues and Expenditures Per \$1,000 of Personal Income, Arizona General Fund	43
2. Ongoing Revenues and Expenditures Per \$1,000 of Personal Income, Including Projections Through Fiscal Year 2015, Arizona General Fund	71

SUMMARY

Background

In order to devise public policies that create jobs, improve the state's economic competitiveness, and balance the budget, a solid understanding of regional economics is a prerequisite. Similarly, an understanding of public finance and the role of state and local governments is necessary.

Regional Economics

Economic Drivers. A significant dichotomy exists in the nature of economic activities in any region. Relatively few companies sell the majority of their goods and services to customers located outside the region, but these companies form the region's economic base and are responsible for the health and growth of the regional economy. In contrast, most companies predominantly sell their goods and services to local residents and local businesses. These "population-serving" activities respond to conditions within the economic base and do not cause economic growth.

Aggregate Growth Versus Gains in Productivity and Prosperity. Just as a dichotomy exists in the nature of economic activities, two categories of economic indicators exist. Some gauges, such as employment, measure aggregate size and growth. Others measure the level and growth of productivity and prosperity—the economic standard of living of individuals. The health of the economy is gauged by such measures rather than by aggregate economic indicators. Productivity growth, not aggregate growth, leads to gains in prosperity: the ultimate economic goal. Aggregate growth rates are unrelated to gains in productivity and prosperity—the overall size and growth of a regional economy has little bearing on the economic well-being of the average citizen.

Based on productivity and prosperity measures, Arizona's economic performance has been mediocre for decades, but that the state compares less favorably now relative to other states than it did during the 1970s and early 1980s. On some of these measures—including earnings per employee, average wage, and job quality—the state underachieves relative to the national average but ranks near the middle of the states. However, the state ranks among the bottom ten on the workforce participation rate and per capita personal income.

Factors Important to Economic Competitiveness and Economic Development. A region must be economically competitive to succeed at economic development and become prosperous. Competitiveness is determined by a long list of regional attributes. The site selection factors deemed most important vary by company and by industry, as well as by the nature of the company's facility.

Among the key base industries—those composed of high-paying, high-technology export companies with prospects for growth—the most important location factors are labor costs, the availability of a skilled workforce, and educational opportunities and quality. For manufacturing facilities, the cost of utilities and the transportation infrastructure (particularly airports) also are rated very highly. Other important factors include the availability of land and leased space, the telecommunications infrastructure, and the education infrastructure. The proximity to universities and research centers also is on the list for headquarters and research and

development facilities. For manufacturing and other facilities, land costs and lease rates, power and water availability, and regulations also are considered to be important.

Some of the important factors are largely beyond the purview of public policy, such as labor costs and real estate costs. If the goal is to improve job quality and raise the standard of living of Arizonans by building high-paying, high-technology industries that can lead the economy for decades to come, then the most important factors that can be influenced by public policy are largely related to education/workforce skills and the quality and availability of the physical infrastructure. Arizona does not compare favorably on these factors.

The Effect of Taxes on Economic Growth. State and local government taxes generally have only a small effect on economic growth. Moreover, taxes represent the price paid for government services consumed, so the cost of taxes must be weighed against the benefits provided by public programs. It is unrealistic to expect a region to maintain low tax burdens while making significant public-sector investments in workforce training, education, and infrastructure.

However, business taxes levied on export businesses, which disproportionately consist of large corporations, can have a noticeable effect on economic performance in some cases. Business taxes for large corporations are high in Arizona relative to other states, reducing the state's economic competitiveness. In contrast, the tax burden for small unincorporated businesses is low, but since few small businesses are part of the economic base, their low tax burden has little effect on the economy. Similarly, the very low tax burden for individuals relative to other states and to Arizona's past has little effect on the economy.

Economic Cycles. Arizona has one of the most volatile state economies in the country. The timing of Arizona's economic cycle usually is quite similar to the national average, but the difference in growth rates from the cyclical peak to trough are unusually large. Rapid population growth is the primary cause of the cyclical nature, causing the construction and real estate sectors, which are highly cyclical, to be relatively large in size.

Public Sector

Economic Rationale for Government. Government intervenes in the private-sector economy when a perfectly competitive private-sector market does not exist or when markets produce more (such as pollution) or less (for example, public safety) than is socially desirable. The private sector is not well suited to efficiently provide various "public goods." A second reason for the existence of the public sector is that the citizens of developed nations have come to believe that the collective whole, administered through the public sector, should provide a safety net for individuals and families.

Fiscal Guiding Principles. The guiding principles of a well-functioning fiscal system—revenues, expenditures, and debt—are well established. Arizona's fiscal system does not compare favorably to these guiding principles, resulting in the fiscal problems being experienced today and during the prior recession.

First, the fiscal principle of accountability—that revenues and expenditures should be linked—has been violated repeatedly since the early 1990s. Second, the weakening of the budget stabilization

fund left the state unable to counter the strong cyclical nature of the Arizona economy that creates revenue reductions and increases in demand for state services during periods of recession. Third, the state's revenue system falls short on most of the 10 principles specific to revenues. Arizona's current revenue system receives a poor evaluation relative to a system of best practices on the guiding principles of stability, predictability, responsiveness, efficiency, competitiveness, neutrality, horizontal equity, vertical equity, and simplicity.

Cyclical nature of Public Revenues and Expenditures. Revenue cyclical nature in Arizona is among the greatest in the nation, in part due to the high cyclical nature of its economy and in part due to the structure of the revenue system. Revenues of the state general fund are especially cyclical, since 90 percent of the revenue comes from two highly cyclical sources: the income tax and sales tax.

While government revenues rise and fall during the economic cycle, demand for government services as a whole grows at a relatively steady pace. However, the demand for some government services is countercyclical, rising more during recessions when people lose their jobs and qualify for government-provided healthcare benefits and various welfare programs. This mismatch between available revenue and spending needs during recessionary periods is at the core of public finance issues.

Government Revenue or Expenditure Limitations. Arizona has a constitutional limitation on expenditures that is expressed as a share of personal income, which incorporates population growth, inflation, and real per capita economic growth. Aligning government growth with economic growth results in no change in the tax burden and no change in the relative size of government over time.

Tax Rates and Government Revenues. Supply-side economics is based on the concept that tax rate reductions stimulate economic growth, with the stimulus so great that government revenue rises despite the lower tax rates. The "Laffer Curve" popularized this theory. For a tax cut to result in a positive effect on economic growth and government revenue, the existing tax rate must be so high that it stifles the economic activity of export companies. However, tax reductions financed by cutting education, infrastructure spending, and other services valued by businesses likely will have a negative effect on economic performance.

A policy of state government tax reductions has been present in Arizona since the early 1990s. Most of the tax cuts have been made to individual tax rates that already were less than the national average and lower than the historical rates in Arizona. Thus, based on the Laffer Curve, Arizona was not generally in a position to benefit from this series of tax cuts, either in terms of enhanced government revenue or economic performance. Further, most of these tax cuts were implemented during economic expansions and were not of much importance to companies in the economic base. Little tax relief was granted to businesses, though the tax burden for some businesses is higher than the national average.

For a *net* positive effect to accrue on state government finance from a tax cut, the state must have underutilized resources. For example, if a state with higher-than-optimal tax rates also has high unemployment and high commercial and industrial vacancy rates, then a reduction in taxes to near the optimal point might stimulate economic growth, putting more residents to work and

more highly utilizing existing facilities. Since labor to support the faster economic growth would not have to be imported to the state, population growth would not accelerate. Thus, the increase in government revenue realized from new economic activities would not be offset by the need to increase public spending to support new residents. Except during recessions, Arizona has had neither high unemployment rates nor high commercial/industrial vacancy rates. Moreover, most of the tax cuts occurred at a time of a booming Arizona economy.

As confirmed by an empirical analysis, the size, nature, and timing of the recent tax cuts in Arizona have had little positive effect either on government revenue or on economic growth. Tax reductions in the state have been made during years when a booming economy has temporarily produced a budget surplus; they have not been the cause of the rapid economic growth.

The Current General Fund Budget. The most notable feature of state general fund revenues is the very high dependence on just two revenue sources: the sales and use tax and income taxes, which account for nearly 90 percent of all revenue. A high proportion of the spending also goes to a limited number of programs. Education accounts for 60 percent of the expenditures, health and welfare for 24 percent, and protection and safety for 11 percent.

Deficits. Since early 2008—when the onset of the latest recession and the implementation of the last substantial tax cut caused revenues to decline—discussions of the state budget have been dominated by the large total deficit in the general fund. The Governor’s Office of Strategic Planning and Budget (OSP) and the Joint Legislative Budget Committee (JLBC) differentiate between two types of deficits. They call the deficit between ongoing revenues and ongoing expenditures a “structural” deficit. This deficit is synonymous with the total deficit between ongoing revenues and ongoing expenditures. The JLBC estimates the size of this deficit at \$3.5 billion in the current year; the OSP estimate is somewhat larger.

The second deficit defined by the OSP and JLBC is the budget deficit in the general fund that remains after one-time efforts to resolve the structural deficit in any year. Because of the use of fund transfers, federal government stimulus monies, revenues from the sale-leaseback of state facilities, and spending reductions, the overall deficit in the current year has been reduced to between \$1.4 billion (OSP) and \$1.5 billion (JLBC).

The total deficit can be divided into two portions. A “cyclical” deficit is a temporary deficit during an economic downturn largely due to a cyclical decline in revenue (but also due to a countercyclical increase in demand for certain public services). A “persistent” deficit is due to a fundamental imbalance between revenues and expenditures that does not vary with the economic cycle. It is caused by permanent reductions in revenues not adequately matched by reductions in expenditures and/or by adding spending obligations without raising a commensurate amount of revenue. The persistent deficit is estimated to be \$2.2 billion in the current fiscal year.

Fiscal Stimulus. An increase in government spending, all else equal, results in a short-term economic stimulus. Increased federal government spending during a recession, as exemplified by the stimulus package passed in 2009, is commonly used, usually with the express purpose of putting unemployed workers back into a job.

Just as an increase in government spending produces a short-term economic stimulus, a decrease in spending has a detrimental short-term impact on the economy. Thus, if state and local governments reduce spending in order to offset a cyclical deficit, this worsens economic conditions during a recession, in turn lowering government revenues even more. An increase in taxes or user fees to combat a cyclical deficit has a less negative effect on the economy. Of course, the best solution to a cyclical deficit is to have enough rainy-day funds set aside.

Comparative Tax Burden. The overall tax burden in Arizona is considerably below the national average and substantially less than in the past. The personal tax burden is very low, with individuals not paying enough to cover the costs they place on the public sector. Overall, the business tax burden is near the national average, but businesses in Arizona pay more in taxes than the costs they impose on the public sector. The tax burden of small businesses is relatively low, but some large corporations have a relatively high burden.

Fiscal Summary. Through the mid-1990s, ongoing revenue (total revenue excluding one-time shifts of funds) in the state government general fund averaged just less than \$50 per \$1,000 of personal income. Ongoing revenue per \$1,000 of personal income has trended down since then. This decline is largely due to the long series of tax cuts, but ongoing revenues have not grown on average as fast as the economy due to the structure of the revenue system.

In addition to the downward trend, ongoing revenue has been highly cyclical over the last decade. Even at the peak of the last economic expansion in fiscal year 2006, during the real estate boom, ongoing revenue per \$1,000 of personal income did not reach the long-term norm. Ongoing revenue has plummeted since then, largely due to the length and depth of the economic recession, but also as a consequence of the most recent tax reductions.

General fund revenue has fallen far more than income during this economic recession, such that revenues in FYs 2009 and 2010 account for only about 3 percent of Arizona income, instead of the historically typical 5 percent. Even after adjusting for the negative effects on income from the recession, the tax burden borne by Arizonans is now by far the lowest in the state's history. Thus, Arizonans in aggregate have the means to pay far more in public revenue than they are being asked to contribute.

Like ongoing revenue, ongoing expenditures since the mid-1990s have been consistently below the historical norm of about \$49 per \$1,000 of personal income and have been highly cyclical over the last decade. Much attention has been given to the rise in expenditures between 2003 and 2008. This increase, however, came from an all-time low. Even at the peak, ongoing expenditures per \$1,000 of personal income were less than \$45: nearly 10 percent less than the historical norm. Thus, no justification exists for claims that abnormally high spending in the mid-2000s caused the state's current fiscal difficulties.

Expenditures have not yet dropped as much as revenues in the current recession due to the one-time adjustments made and due to the amount of spending protected by voter initiative and/or the federal stimulus program. Of course, a \$1.5 billion deficit remains to be resolved. Still, spending per \$1,000 of personal income in FYs 2009 and 2010 are among the lowest on record, along with the figures during the last recession.

Scenario 1: Inaction

This section examines Arizona's future if no substantive action is taken to deal with the state's economic and fiscal problems.

Job Creation: Nature and Timing of Economic Recovery in Arizona

At the end of 2009, the Arizona economy was just beginning to recover from its longest and deepest downturn since the 1930s. Given the extent of the real estate problems still to be resolved, the upcoming recovery is likely to be even slower than the previous two. Modest economic growth is expected through 2010 and 2011. Growth should then accelerate, but the peak job level of 2007 is not expected to be reattained until 2014. Total economic growth is unlikely to be as strong in the upcoming expansion as in the last two.

Economic Competitiveness

Arizona's fast growth, other than during recessions, is an indication that its export base is growing quickly despite the state's economic competitiveness not being rated as a strength. (Evaluations of the state's business climate range from good to poor.) It is likely that Arizona's natural attractions—including climate, open spaces, and lifestyle—continue to offset its weaknesses, at least for some types of base economic activities. However, the state's subpar job quality, with no improvement occurring over time, is a sign that these natural attributes are not enough to compensate for its shortcomings among the key base industries.

Ignoring the state's fiscal problems, the state should continue to grow for a long time even if positive actions to improve economic competitiveness are not undertaken. Of course, the quality of the growth will remain a concern, as will the high cyclicity of the economy.

The possibility of not reversing the spending reductions already made over the last two years and of substantial further reductions in public expenditures clouds this outlook. Reductions in programs—education, job training, and provision and maintenance of infrastructure—important to the key base industries will have serious long-term consequences.

The lowering in workforce quality from reductions in elementary and secondary (K-12) and higher education spending likely would end any pretense the state has of attracting the key base industries. A deteriorating infrastructure also likely will have a significant negative effect on economic competitiveness.

State Budget: An Assessment of Current and Future Conditions Absent Any Action

A large budget deficit of around \$1.5 billion remains in FY 2010. The loss of a substantial portion of federal stimulus monies—currently accounting for at least \$1.25 billion of revenue to the general fund—will cause a significant loss of revenue in FY 2011, but largely will be offset by a cyclical rebound in ongoing revenues. However, given the large continuing increases in demand for public programs such as the Arizona Health Care Cost Containment System (AHCCCS) and food stamps, expenditures will need to be higher in FY 2011 than in the current fiscal year. Assuming no action is taken to balance the current year's deficit and that it rolls into FY 2011, the deficit in FY 2011 likely will be approximately \$2 billion.

Given the constitutional requirement to balance the budget, Arizona's current budget deficit will need to be resolved. However, since a deficit can be carried into the next year provided it is resolved that year, the resolution of the deficit need not occur in the next few months. Based on the assumption that there will continue to be no willingness to address the issue through revenue enhancements, or that any revenue enhancements will address only a portion of next year's projected \$2 billion deficit, then a significant additional spending reduction will be needed.

The latest budget for FY 2010—after the reductions made during the two special sessions late in 2009—includes \$9 billion in general fund appropriations. This is \$1.1 billion (11 percent) less than the original budget for 2008. Incorporating the effects of inflation and increased demand for state services, the effective decrease is approximately \$1.4 billion.

Given the existing spending protection provided by the federal stimulus program, it will be impossible to reduce spending enough in the current fiscal year to balance the budget without all but eliminating the correctional system (that is, releasing nearly all prisoners) and other unprotected programs. In FY 2011, less funding will be protected as the federal stimulus protection phases out. By FY 2012, the temporary protection from the federal program will be gone, but considerable funding, mostly for K-12 education and AHCCCS, still will be protected.

Even if the assumption is made that the existing protection and federal mandates would not be an issue in making spending reductions, it will be a significant challenge to reduce general fund spending by \$2 billion (22 percent) more. Education receives 60 percent of the funding and health and welfare receives 24 percent. Even if all general fund support were eliminated for all programs other than education and health and welfare—a completely unrealistic scenario—a deficit of nearly \$700 million would remain.

Thus, it will be impossible to reduce spending by \$2 billion without significant reductions to education and/or health and welfare programs. Even before spending reductions began in 2008, Arizona's spending on these programs was below the national norm. Based on Census Bureau data, per student funding for education in 2007 was second lowest in the country and higher education funding per student also was well below average. Similarly, spending on public welfare was considerably below the norm, despite the state's higher-than-average needs, as expressed in measures such as the poverty rate.

An additional reduction in spending of \$2 billion will damage the economic future of the state and create great hardship now, in the midst of the worst economic conditions since the great depression, on the state's most vulnerable residents. Further spending cuts also will depress an economy struggling to recover. Economic models indicate that a \$2 billion reduction in state spending would cause the loss of another 44,000 jobs—20,000 of them in the private sector.

In the longer term, the negative effects of this scenario probably will first affect the key base industries. There likely will be a period of time in which the state continues to grow in employment and population, but during which the state declines to even further below average in measures of productivity and prosperity, including job quality. Eventually, employment and population growth in Arizona will slow substantially, as it has in all mature states and nations. A policy of inaction now will advance the date of the eventual slowdown, perhaps by decades.

Scenario 2: Positive Action

This section presents an alternative future for Arizona based on a plan that positively deals with the state's economic and fiscal problems. Public policy recommendations are made for balancing the budget, creating jobs in the short term, and enhancing the state's economic competitiveness. Summarized by year, the plan includes the following:

Fiscal Year 2010 (through June 30, 2010)

Fiscal:

1. Let the remaining FY 2010 deficit roll into FY 2011.
2. Raise revenue for FY 2011:
 - A. Restore and expand funding to the Arizona Department of Revenue.
 - B. Increase federal funding.
 - C. Properly account for photo radar receipts.
 - D. Institute a home arrest program for nonviolent offenders.
 - E. Create a utility excise tax.
 - F. Increase the motor vehicle fuel tax.
 - G. Make changes to the sales tax.
 - (1) Temporarily increase the general sales tax rate by 1 percentage point.
 - (2) Resume taxing food to be consumed at home.
 - (3) Expand the existing low-income credit for increased excise taxes.
 - (4) Eliminate the sales tax collection tax credit.
 - H. Make changes to the property tax.
 - (1) Restore the statewide property tax.
 - (2) Phase out the homeowner's rebate.
3. Create a fiscal system study group.

Job Creation:

1. Take full advantage of the federal stimulus funding received.
2. Release funding for the SPEED program immediately.
3. Undertake long-term financing of additional infrastructure building.

Economic Competitiveness:

1. Create an economic development study group.
2. Form an education study group.

Fiscal Years 2011 and 2012

The study groups present recommendations for comprehensive solutions to the state budget and economic development issues.

Fiscal Year 2013

Legislation regarding comprehensive solutions to the state budget and economic development issues is passed for implementation in FY 2014:

Fiscal:

1. Increase tax revenue.
 - A. Sales tax.
 - (1) Reduce the tax rate to 4 percent.
 - (2) Broaden the tax base to include various services.

- B. Property tax.
 - (1) Create a new fund for the School Facilities Board, with revenue coming from the property tax.
 - (2) Eliminate the constitutional 1 percent cap on residential real estate taxes for primary purposes.
 - (3) Exempt the first \$xx,000 of the assessed value of improved property, with the revenue lost offset by an increase in the statewide tax rate.
- C. Income tax.
 - (1) Increase personal income tax rates.
 - (2) Decrease the corporate income tax rate to the highest personal income tax rate.
 - (3) Eliminate some of the tax credits.
 - (4) Reserve some of the revenue from the corporate income tax to be used for corporate incentives.
- D. Other taxes.
 - (1) Increase the motor vehicle license tax.
 - (2) Increase in the luxury tax on alcoholic beverages.
- 2. Increase user fees.
 - A. Implement a health care provider fee.
 - B. Increase other fees.
- 3. Other.
 - A. Seek additional federal funds through a centralized effort.
 - B. Improve money management.
 - C. Strengthen the budget stabilization fund.
 - D. Improve accountability.

Economic Competitiveness:

- 1. Improve education and job training.
- 2. Expand and improve the physical infrastructure.
- 3. Tax policy.
 - A. Reduce or eliminate the personal property tax applied to business equipment.
 - B. Set the assessment ratio for business property taxes to be equal to those of residences.
- 4. Create a statewide economic development policy with flexibility to account for varying conditions across the state.

Conclusion

Adopting the recommendations in scenario 2 will allow the state to begin to catch up after decades of neglect. However, progress will be slow, even if all of the recommendations are adopted and funded. Had Arizona changed its course in the 1980s when it was a much less populous state, it would have been easier and quicker to reach its goals. Now, with an economy of 3.3 million workers and a state of 6.6 million residents, doing everything right will yield only slow improvements. Moreover, economic competition continues to strengthen from other regions of the country and from other countries.

The alternative, though, is clear. Without action, the state will continue to deteriorate relative to the nation until it reaches a point that it no longer is a desirable location for businesses or individuals to locate—despite its natural attributes. By the time that happens, the quality of life of its residents will have declined—the state will have descended to second-class status.

BACKGROUND¹

In order to devise public policies that create jobs, improve economic competitiveness, and balance the budget, a solid understanding of regional economics and of the role and the financing of the public sector is necessary. This section provides an overview of these topics.

Regional Economics

A regional economy can be any geographic area. States are the focus in this section.

Economic Drivers

A significant dichotomy exists in the nature of economic activities in any region. Relatively few companies sell the majority of their goods and services to customers located outside the region, but these companies form the region's economic base and are responsible for the health and growth of the regional economy. In contrast, most companies predominantly sell their goods and services to local residents and local businesses. These "population-serving" activities respond to conditions within the economic base and do not cause economic growth.

Export, or basic, activities take many forms. The classic examples are agriculture and mining, whose locations are dependent on local attributes of the land. These sectors are not mobile. Tourism and retirement migration also are basic economic activities. They are similar to agriculture and mining in that their presence is in part due to local natural attributes (such as climate, mountains, and bodies of water). However, the aspects of quality of life that are determined by human decisions and activities also influence the number of tourists and retirement-aged migrants that any region receives.

In contrast, most companies that form the economic base can locate anywhere. For example, regions within the United States compete with one another and with the rest of the world for manufacturing facilities. Other examples of mobile basic industries include insurance carriers, call centers, and some components of the wholesale trade and transportation sectors.

The presence in a region of mobile export businesses is due to the region's economic competitiveness (business climate). A long list of regional factors, discussed in a following subsection, determine the business climate and influence location decisions of manufacturers and other mobile export businesses.

Just as private-sector markets that work most effectively allocate resources freely across competing uses to the ones that are most likely to result in growth, public-sector policies need to distinguish between economic-base and population-serving industries to the extent possible in order to maximize economic competitiveness and growth. For example, providing tax cuts and incentives to population-serving companies serves no economic purpose.

However, not all export industries have an equal effect on the regional economy. The wage level is one important distinction. A low-paying base industry such as tourism has a much lesser

¹ Parts of this section were taken from the background report for the 95th Arizona Town Hall, *Riding the Roller Coaster: Government Revenue in Arizona*, November 2009 (<http://www.aztownhall.org/>). Information also was taken from the three volumes of *Public Finance in Arizona*, December 2008, Arizona State University, Office of the University Economist (<http://economist.asu.edu/public-finance>).

impact per employee than does a high-paying base industry, such as high-technology manufacturing. A second practical distinction is the industry's prospect for growth. Some base industries are unlikely to be a source of future growth. Mining, for example, is limited by dwindling natural resources. Many of the mature manufacturing industries have limited growth prospects.

The United States, and each of its states, has a developed economy. It cannot compete on the basis of cost with competition now coming from countries such as China and India. In the past, Arizona attempted to attract cost-sensitive operations but that strategy is no longer viable. Instead, Arizona and the rest of the country in the 21st century must compete based on innovation and the development of new and better technologies. Because of this, education and research and development have become particularly important factors in determining the economic competitiveness of a region.

Aggregate Economic Growth Versus Gains in Productivity and Prosperity

Just as a dichotomy exists in the nature of economic activities, economic indicators can be placed into two categories. Some, such as employment, measure aggregate size and growth. Others measure the level and growth of productivity and prosperity.

Historically, the emphasis in Arizona has been on aggregate economic growth. While employment generally has been the most widely used indicator due to its timeliness, it does not reflect differences in wage levels. An aggregate economic measure that is expressed in dollars, such as gross product or personal income, is more informative.

Less attention has been placed on productivity and prosperity indicators in Arizona, even though the health of the economy is gauged by such measures rather than by aggregate economic indicators. Productivity growth, not aggregate growth, leads to gains in prosperity: the ultimate economic goal. Aggregate growth rates are unrelated to gains in productivity and prosperity.

Productivity and prosperity indicators are measured per person or per employee. Such indicators are appropriate to use to compare regions of widely varying sizes, and to compare data for one region as it grows over time. Any economic indicator measured in dollars must be adjusted for inflation if data for one time period are compared to another period.

Factors Important to Economic Competitiveness and Economic Development

A region must be economically competitive to become more prosperous. Competitiveness is determined by a long list of regional attributes, sometimes called the business climate. Economic competitiveness is necessary for all three forms of economic development: attracting companies to move to the region, encouraging existing companies to remain and expand in the region, and fostering new businesses.

The regional factors deemed most important vary by company and by industry. Yet most rankings of location factors do not distinguish between the many kinds of export activities. The most important factors considered by the average company when looking to move or to locate a new facility includes

- The quality and availability of the workforce.

- The quality and availability of the physical infrastructure. Transportation—airports and surface transportation—and utilities are most often mentioned.
- Cost factors. Labor costs are the most important of the cost factors, but tax burdens, real estate costs, and energy costs all are common considerations. Once a region has been selected as a finalist in a company’s site selection process, the availability and flexibility of incentives often makes a difference.

Other regional attributes of importance include the availability of land and buildings and the regulatory environment.

Some of the important location factors, such as labor and real estate costs, are largely beyond the purview of public policy. In contrast, the public sector is largely responsible for the transportation infrastructure and public education; the latter is a significant contributor to workforce quality. While taxes can be an important location factor, they must be evaluated in the broad context that they are the price paid for the public infrastructure and public services that are important to businesses.

The list of important location factors can be very different for the high-paying, high-technology industries that are expected to lead the nation’s economic growth during the 21st century. (Through the rest of this report, these are referred to as the “key base industries.”) Within these industries, the list of factors important in siting a headquarters or research and development (R&D) facility can be quite different from the most important factors in locating a manufacturing plant or some other type of facility.

In order to distinguish between the different industries and different types of facilities, economic development experts in the Phoenix area were polled regarding what they believed to be the most important factors.² They were asked to differentiate between the type of company facility and were asked to list the factors most important to each of eight export industry clusters that either were already of particular significance in the Phoenix area or were a target for future growth. The selected clusters were aerospace, bioindustry, call centers, environmental technology, plastics, software, transportation, and “high tech” (other than the high-tech clusters mentioned specifically, and including electronics). Each of these clusters was selected either in the original Arizona Strategic Planning for Economic Development effort during the early 1990s or shortly thereafter. Several, but not all, of these clusters are high paying and are heavy users/producers of technology.

In general, the most important factors for both headquarters/R&D facilities and manufacturing/other types of company facilities were labor costs, the availability of a skilled workforce, and educational opportunities and quality. For manufacturing/other types of facilities, the cost of utilities and the airport infrastructure also were rated very highly, though neither of these even made the list of important factors for headquarters/R&D facilities.

Several other factors also were considered to be important. Those on the list of both headquarters/R&D facilities and manufacturing/other facilities included the availability of land and leased space, the telecommunications infrastructure, and the education infrastructure. The proximity to universities and research centers also was on the list for headquarters/R&D

² “Site Selection Factors Vary Widely by Economic Cluster,” *Arizona Business*, November 2000.

facilities. For manufacturing/other facilities, land costs and lease rates, power and water availability, and regulations also were considered to be important.

Notably lacking from this listing are business taxes and incentives. Each was considered to be important for certain types of facilities in some clusters, but overall was not considered to be as important as the factors mentioned above for the selected clusters. Also notable is that two of the three most important factors to all types of facilities are related to education: the availability of a skilled workforce, and educational opportunities and quality (important to the company as a component of a skilled workforce and important to the company's employees as a component of their quality of life). Two additional education factors were considered to be important: the education infrastructure and proximity to universities and research centers.

Thus, if the goal is simply for Arizona to grow, then business taxes and incentives are among the few top factors that can be influenced by public policy, along with the transportation infrastructure and the quality of the workforce. However, if the goal is to improve job quality and raise the standard of living of Arizonans by expanding the key base industries, then the most important factors that can be influenced by public policy largely fall into two categories: (1) education and workforce skills, and (2) the quality and availability of the physical infrastructure (not just transportation).

Education and Job Training

Arizona's economic competitiveness is hampered by the poor quality of its workforce. Achievement tests indicate that Arizona's elementary and high school students do not perform as well as their peers nationally. A lower proportion of the adults who were educated in Arizona have completed high school. Many employers report difficulty finding enough individuals with basic work skills.

These limited educational attainments and work skills are a particular disadvantage in the key base industries. These high-wage companies require sophisticated technological skills, even among workers who are not required to have a college degree. Historically, companies located in Arizona have relied on in-migrants to fill many of their jobs, but it is more expensive for companies to import skilled workers from outside the state and considerable competition for these skilled workers exists.

Even if attracting workers was not an issue for employers, the poor educational achievement and attainment of Arizona students is creating an underclass among its residents. The state's poverty rate is regularly higher than the national average and the workforce participation rate, even among those in the prime working ages of 25 to 54, is below average. Some of these struggling Arizonans are working, but in low-wage jobs, while others do not work, largely due to an inability to compete for available jobs. Not only do people in this group not contribute much to Arizona's economy, they disproportionately use public services due to their low incomes and lack of health insurance.

While a number of factors contribute to the low educational achievement and attainment of the state's residents, the state's education infrastructure is a significant concern. Arizona spends less on elementary and secondary education than nearly every other state, and public investment in

higher education also is below average. Little support is provided for research; the funding for Science Foundation Arizona has been eliminated. For a state as large as Arizona—in terms of geographic area and population—having only three state universities means that few locations in the state offer the proximity to research universities that many companies in the key base industries require. Further, potential employees for such companies are concerned about the quality of the educational system that their children will attend.

Arizona's education spending has dropped considerably over time relative to other states on an inflation-adjusted (real) per student basis. Most of the funding for elementary and secondary (K-12) education comes out of the state's general fund. Total spending per student from all state and local government funds, excluding capital outlays, was only a little below the national average through the 1980s, but has been 33-to-37 percent below average since 2001. The state's rank among the 51 'states' (including the District of Columbia) has been 50th since 2001. Even after adjusting the per student figures for Arizona's low per capita personal income, the state's rank still has been 50th since 2001. Expenditures per student per dollar of per capita personal income were 23-to-29 percent below average over this period.

Higher education expenditures per full-time-equivalent student per dollar of per capita personal income also have dropped since the mid-1980s relative to the U.S. average. Total spending, excluding capital outlays, was 5-to-10 percent less than the national average during the 1980s, but has fallen to 15 percent below average. The state's rank has been in the mid-30s in recent years.

The other aspect to producing a quality workforce consists of job training. While some job training occurs within the public education system, particularly at community colleges, the state has a variety of other job training programs. However, these programs are viewed as inadequate by many employers, especially those in the key base industries.

Infrastructure

The availability of a quality infrastructure is consistently rated as one of the most important factors affecting economic development. The physical infrastructure of the state, particularly its transportation system, already is a concern. Reports produced in 2008³ detailed the amount of spending that is needed to improve the state's existing infrastructure to be economically competitive and then to keep up with the expected growth in the Arizona population. Capital spending in the state, especially for transportation, has consistently been lower relative to other states than would be expected of a state that generally ranks second in the nation in population growth.

The availability and quality of the physical infrastructure in Arizona generally is not perceived favorably. With the limited investment in infrastructure in the state and with the size of the budget difficulties facing state and local governments that will continue even after the end of the

³ L. William Seidman Research Institute, W. P. Carey School of Business, Arizona State University, *Infrastructure Needs and Funding Alternatives for Arizona: 2008-2032*, May 2008 (<http://wpcarey.asu.edu/seid/ccpr/OtherReports.cfm>) and *Preparing for an Arizona of 10 Million People: Meeting the Infrastructure Challenges of Growth – Background Report*, October 2008 (<http://wpcarey.asu.edu/seid/ccpr/P3reports.cfm>).

recession, the state's physical infrastructure is at risk of becoming a major negative factor on its economic competitiveness.

The Effect of Taxes on Economic Growth

Nearly any position on the relationship between state and local government taxes and economic performance is supported in the published literature. However, the bulk of the modern literature indicates that state and local government taxes have only a small effect on economic growth. Many factors affect economic growth, as discussed in the preceding subsections.

Despite the attention given to taxes, state and local government tax payments are a minor expense for most businesses. All state and local government taxes and most federal government taxes—Social Security and payroll taxes, unemployment insurance taxes, excise taxes, import and tariff duties, business license and privilege taxes, and the environmental tax but not the federal income tax—account for only a little more than 2 percent of the operating income of the average business. Thus, state and local government taxes are less than 2 percent of business operating income for most businesses—a lesser expense than the compensation of company officers.

Moreover, taxes represent the price paid for government services consumed. Many state and local government services—such as the education of children and the provision of police protection—are of high value to individuals and businesses alike.

State and local government business taxes receive attention because many state and local governments grant tax incentives, tax credits, and tax exemptions to businesses. A rational profit-seeking business will avail itself of such opportunities. In site location decisions, such tax breaks are a deciding factor only if two or more locations are viewed essentially equally on all other factors.

While state and local government taxes are not nearly as economically important as sometimes portrayed, business taxes are one of the location factors. Business taxes for large corporations and export businesses are high in Arizona relative to other states, reducing the state's economic competitiveness.

In contrast to large corporations, the tax burden for small unincorporated businesses is low. The difference in relative tax stems from two factors: (1) unincorporated businesses file income taxes on the individual tax form—individual tax rates are lower than the corporate tax rate; and (2) property taxes for commercial and industrial property of larger companies (those with a high assessed value) are high relative to other states while other business property tax burdens are moderate.

Since relatively few small businesses are part of the economic base, their low tax burden has little effect on the economy. Similarly, the very low tax burden for individuals relative to other states and to Arizona's past has little effect on the economy. (Tax burdens are discussed in the "Public Sector" section that follows.)

Despite business tax burdens being of significance to economic competitiveness and despite the relatively high tax burden borne by many of Arizona's leading companies, relatively few of the tax cuts implemented since the early 1990s have benefitted export businesses. The early rounds of tax cuts almost entirely were focused on individuals, as discussed in more detail in the "Public Sector" section. Overall, the tax cuts have been dominated by reductions to the personal income tax. Thus, it comes as no surprise that an empirical investigation found that no observable economic effects have been received from the numerous and substantial tax reductions that have been passed since the early 1990s, which overwhelmingly have benefitted individuals (and population-serving businesses).

As in other states, businesses pay more for public services than the costs they place on state and local governments in Arizona. In contrast, individuals in Arizona do not adequately pay for the public services they use. The reduction in the individual tax burden over the last 15 years means that businesses subsidize individuals even more than in the past. This is of little significance to the population-serving businesses, which can pass the taxes on to their customers since all of their competitors are subject to the same taxes. Export companies are not able to pass on local costs since their competitors are overwhelmingly located in other regions and other countries.

In conclusion, state and local government tax policies can have an appreciable effect on economic performance only under specific conditions. An effect will only occur when tax policies are focused on export businesses. In general, the effect will be greatest when a tax burden on a specific tax, such as the business personal property tax, that is high relative to competitor states is lowered significantly. Otherwise, tax policy is an inefficient way to stimulate the economy. Investment in infrastructure and education has been shown to have a greater effect on economic growth.

Economic Cycles and Trends⁴

Economic growth rates around the globe rise and fall over a period of a few-to-several years. The typical cycle consists of a period of economic growth—which sometimes is divided into recovery, expansion, and slowdown phases—and a shorter period during which the size of the economy contracts (after adjustment for inflation). In the United States, the typical economic cycle through the 1950s had a length of only about four years. Since then, some cycles have been longer, up to 10 years in length.

The economy of each region is cyclical, though not all regional economic cycles coincide with the national cycle. The timing of Arizona's economic cycle usually is quite similar to the national average, but the difference in growth rates from the cyclical peak to trough are unusually large. In fact, Arizona has had the second-most cyclical economy in the nation since 1950.

All of the states with the most volatile economies are in the South or West. The common link between these states is their rapid population growth. Nationwide, the construction and real estate sectors experience substantial cyclicity. In fast-growing states in which these sectors

⁴ Parts of this subsection were taken from Marshall Vest of the University of Arizona, Chapter 10 of the background report for the 95th Arizona Town Hall, *Riding the Roller Coaster: Government Revenue in Arizona*, November 2009 (<http://www.aztownhall.org/>).

account for an above-average share of economic activity, the overall economy is relatively more cyclical.

Some industries are not as cyclical as others and some industrial cycles do not follow the national business cycle. Thus, economic diversification can help to reduce the overall cyclicity of a regional economy, but the effects of diversification are modest.

Relative to the national average, in the typical economic cycle Arizona's economy grows much more rapidly during economic expansions but declines as much during recessions. During expansions, Arizona's much more rapid aggregate economic growth results mostly from its much greater population growth rate, not from a better performance on productivity and prosperity indicators.

In contrast to cycles, trends reflect changes that are more long lasting. For example, the decline in relative importance of the agriculture and mining sectors is a trend. In public finance, a trend exists in which the collection of sales taxes based on goods does not keep pace with economic growth.

An Evaluation of Arizona's Economy

Arizona has had the weakest economy in the nation during the recession that began late in 2007, in terms of employment change. This, of course, is not representative of the state's long-term aggregate economic growth, just as the boom conditions present from 2004 through 2006 were not representative. Arizonans have a tendency to become too optimistic when economic conditions are strong, and too pessimistic when they are weak. The following evaluation avoids these cyclical extremes by focusing on long-term averages and on productivity and prosperity measures. However, even these measures are relatively volatile in Arizona over the course of an economic cycle.

While many Arizonans have long focused on growth and increasing size (of the economy and population), such a focus has resulted in nearly the most cyclical economy in the nation. Cyclicity is damaging to individuals, who experience economic dislocations, such as reduced work hours and loss of jobs, during recessions. The cyclicity of the economy also affects the public sector, which in Arizona generally is either struggling to keep up with population growth or facing a significant cyclical deficit. As discussed in the first report from the Arizona Strategic Planning and Economic Development effort in 1990, the emphasis instead should be on measures of productivity and economic well-being.

In the near term, of course, employment issues cannot be ignored due to the substantial job losses experienced in Arizona over the last two years and the state's relatively high unemployment rate. A discussion of near-term job creation policies is therefore included in this *Roadmap*. Most of the discussion of economic policies, however, focuses on the longer term and on public policies that will enhance the productivity of the state's workforce, improve the economic standard of living, and reduce, to the extent possible, the cyclical dislocations that occur every time the economy slows.

An evaluation of productivity and prosperity measures indicates that Arizona's economic performance has been mediocre for decades, but that the state compares less favorably now relative to other states than it did during the 1970s and early 1980s. On some of these measures, the state underachieves relative to the national average but ranks near the middle of the states. For example, earnings per employee—a proxy for productivity—in 2008 ranked 23rd but was 7.5 percent less than the national average, compared to only 1-to-5 percent below average in the 1970s and early 1980s. The average wage in 2008 ranked 22nd but was 5.5 percent below average, down from 1-to-5 percent below average in the 1970s and early 1980s. Per capita personal income in 2008 compared poorly with a rank of 42nd; it was 15 percent below average—after ranging from 5-to-11 percent below average in the 1970s and early 1980s. Much of the cause of the relatively poor income performance is the state's low workforce participation rate. In 2008, Arizona's rate was second lowest in the nation at 11 percent below average, though down only marginally from prior conditions.

Some of the factors causing this subpar performance on productivity and prosperity indicators, such as wage levels, are not under the control of policymakers. Others, however, can be influenced directly or indirectly.

Job quality is the starting point to prosperity. Defined only on the basis of wages, Arizona's job quality is about 2 percent less than the national average, but ranks among the middle of the states. Arizona's occupational mix is only marginally below the national average, but its industrial mix is nearly 2 percent below average. If a broader measure of job quality were available, one that includes benefits such as health insurance, Arizona may compare less favorably. The state is further below average on nonwage compensation than on wages and salaries. This likely relates to the state's poor economic competitiveness for the key base industries, which not only pay higher wages but also offer better nonwage compensation packages.

While a diversification of Arizona's economy is often suggested as a cure for its ills, the reality is that the economy is relatively diversified. However, as seen in its below-average industrial mix, the diversification has been attained by an overabundance of low-paying industries. Thus, strategies to diversify the economy need to focus on the key base industries.

An overdependence on the cyclical construction and real estate sectors has often been mentioned as a problem, but only a small portion of construction-real estate serves as an economic driver. The reality is that these sectors respond to growth in the state's economic base and will remain disproportionately large in Arizona as long as the state's growth rate remains high. Arizona is a fast-growing state primarily due to natural factors such as climate, but the state's long-present pro-growth stance also has contributed to its fast growth. A focus on growth does not benefit productivity or prosperity. Across the nation, the rates of population and employment growth are unrelated to gains in productivity or prosperity. However, fast growth is the largest factor contributing to the state's very cyclical economy, and thus a de-emphasis on overall rates of growth in favor of targeted growth of the key base industries is recommended.

Wages in Arizona are below average, even after considering the cost of living. The low average wage is in part due to the below-average job quality, a factor that can be addressed by public

policy. However, much of the below-average wage is apparently due to the willingness of individuals to work for lower wages in Arizona in exchange for perceived noneconomic advantages of living in the state (climate, lifestyle, etc.).

Incomes in Arizona are further below average than wages. While a number of factors contribute to the low incomes, the major factor other than the low wages is the low workforce participation rate in Arizona. The below-average employment-to-population ratio is in part due to the state's slightly above-average shares of its residents who are children or senior citizens. Early retirees who move to the state when they retire also contribute to the low ratio. However, even among the prime working-age population of those 25-to-54 years of age, the workforce participation rate is below average.

The low workforce participation rate may in part result from factors that cannot be influenced, such as cultural norms regarding the workforce participation of women. However, some of the low participation almost certainly is a result of the uncompetitive job skills of individuals who grew up in Arizona. They are outcompeted for available jobs by in-migrants with stronger skills and educational attainments.

Workforce participation rates are particularly low in some of Arizona's less-populous counties where educational attainments are the weakest. In certain rural parts of the state, including some of the American Indian reservations, weak job creation also contributes to the low workforce participation. Thus, while the state needs to concentrate on the key base industries, it must have a flexible plan that focuses on other base industries in some rural areas of the state.

Public Sector

The unusual attention on state and local government taxes in Arizona means that an understanding of why these governments exist and how they are financed is of particular importance.

The Economic Rationale for Government⁵

The private sector efficiently provides most goods and services, using the price as the mechanism to balance supply and demand. Competition among companies ensures that goods and services are provided efficiently and are priced equitably. Government intervenes in the private-sector economy when these conditions are not met—that is, when a perfectly competitive private-sector market does not exist or when markets produce more (such as pollution) or less (for example, public safety) than is socially desirable. Economists describe these private-sector limitations as “market failures.”

The private sector is not well suited to efficiently provide various “public goods,” including those best provided by state and local governments:

- For some goods, the price system does not work because consumers will not voluntarily reveal their true preferences. For example, if government asks residents to voluntarily pay for a park, they might believe that their neighbor will also contribute, and so they name

⁵ Parts of this subsection were taken from Jeffrey Chapman of Arizona State University, Chapter 2 of the background report for the 95th Arizona Town Hall, *Riding the Roller Coaster: Government Revenue in Arizona*, November 2009 (<http://www.aztownhall.org/>).

an amount considerably less than what the park is worth to them. This attempt to “free ride” results in an inefficient provision of parks.

- The private sector generally cannot provide adequate physical infrastructure. Building infrastructure requires high upfront capital expenditures that can be recovered only over a long time period. Charging fees, such as for residential streets, is problematic. Thus, if left to the private sector, a less than optimal supply of physical infrastructure would exist. Yet, the benefits of infrastructure affect both societal welfare and economic development. Schools and public hospitals directly affect education and health levels. Roads and airport facilities directly enhance economic development as well as serve individuals. Because of the expense and financing requirements of capital infrastructure, government intervention is often necessary.
- In some cases it is impractical or inefficient for private-sector companies to compete to provide a public service. Sellers and buyers that are large enough to affect prices attempt to underproduce and realize higher prices for their output than the prices that would be determined by an efficient, competitive market. Government may intervene to control prices—such as for electricity—or may otherwise regulate such private-sector activities. In the case of the provision of utilities, a monopoly originally was granted because of the inefficiency of producing multiple water pipelines or electricity transmission lines to serve the same residents and businesses.
- Some services, such as garbage collection, are provided either directly by municipalities or are contracted to a single private-sector company because of efficiency issues. For example, having the garbage truck stop at each house in succession rather than drive long distances between customers is more cost effective.

A second reason for the existence of the public sector is that the citizens of developed nations have come to believe that the collective whole, administered through the public sector, should provide a safety net for individuals and families. Historical abuses of disadvantaged individuals and severe repercussions from circumstances out of the control of individuals, such as job losses and other hardships during the Great Depression, led to these social welfare concerns.

All taxpayers contribute to the funding for the safety net, even though they may never utilize its features. As demonstrated in the severe recession that is just ending, individuals and families that never before had experienced a need for public assistance lost their jobs, health insurance, and homes.

Public education is a special example of the social welfare motivation for the existence of the public sector. Most parents could not afford to pay the cost of schooling for their children at the time the schooling is consumed. Parents usually are relatively young and do not earn as much as they will later in life. However, their needs are greater than they will be later in life: they experience many expenses related to their children, they need to build up their savings account for a “rainy day,” and they need to purchase assets such as homes and automobiles. Thus, the costs of educating their children are spread throughout their taxpaying lifetime. Those who do not have children still contribute because of the societal benefits of an educated populace, including lower crime rates, less need for public services, and higher wages for all.

Fiscal Guiding Principles

A “fiscal” system incorporates the revenue system, the expenditure system, and debt. Agreement exists nationally among fiscal experts regarding the guiding principles of a well-functioning fiscal system, but the list of principles can be organized and grouped in a number of ways, and the terminology and definitions of terms can vary. Ten principles specific to the revenue system are listed below, ordered from the broadest considerations to more micro concepts. These are followed by a key principle applicable to the entire fiscal system.

1. Stability: The revenue system should minimize year-to-year fluctuations in revenues over the economic cycle.

- Multiple revenue sources should be employed, including taxes, user fees, and federal revenues. Income, wealth, consumption, and transactions all should be taxed.
- An adequately funded budget stabilization fund should be used to offset the inevitable cyclical fluctuations in revenues.

2. Responsiveness: The revenue system should produce revenues that keep pace with long-term growth in the state’s economy.

- The growth of government generally should be targeted to keep pace with economic growth (population plus inflation plus real per capita economic gains).
- The system should be designed to collect revenues from expanding activities.
- Over time, the system should be updated as necessary to keep pace with changing technology, economic mix, and societal structure.

3. Predictability: A stable and responsive revenue system produces a predictable stream of revenues, benefiting taxpayers and policymakers.

- The revenue system should be designed based on these guiding principles, then changed only as necessary. Frequent ad hoc changes negatively affect predictability as well as other guiding principles.
- An adequately funded budget stabilization fund greatly enhances predictability.

4. Efficiency: Revenue policy should have minimal impacts on economic behavior.

- Revenue sources should be broad based with low marginal tax rates.
- Revenue collections should be matched to public benefits to the extent possible.

5. Competitiveness: Revenue policies should promote economic vitality and prosperity.

- The division of the revenue burden between businesses and individuals should be equitable.
- The revenue system should be consistent with that of other states to minimize disincentives for investment. Particular attention should be paid to policies affecting basic (export) industries.

6. Exportability: The revenue system should be designed to tax nonresidents as well as residents.

- Taxes paid by tourists, seasonal residents, and other nonresidents as well as by residents should be utilized.
- Taxes and user fees that particularly target visitors also should be employed.

7. *Neutrality*: Differential treatment of similar economic activities should be minimized.
- The use of tax credits and exemptions should be limited.
 - Tax credits and exemptions should be periodically evaluated to determine if they contribute to economic development and the common good.
8. *Horizontal Equity*: Revenue policies should treat people of equal means similarly.
- The definition of “equal means” may vary by revenue source, such that the evaluation of horizontal equity needs to be made by source.
9. *Vertical Equity*: The overall tax structure should minimize regressivity.
- Tax payments as a proportion of income should not be higher for those with lower incomes than other taxpayers.
 - Some fiscal experts contend that the overall tax structure (including federal taxes) should be progressive, with tax payments as a proportion of income rising with income.
10. *Simplicity*: The revenue system should be designed to minimize costs of compliance and administration.
- The revenue system should be easily understood by affected businesses and individuals and should minimize compliance costs.
 - Revenue rules should be easy to administer by government agencies and should minimize administrative costs.

Each of these 10 guiding principles is specific to the revenue system. However, revenues cannot be examined independently from the rest of the fiscal system—expenditures and debt. The key guiding principle that applies to the entire fiscal system is sometimes labeled as accountability:

Accountability. Revenues and expenditures should be linked.

- Determine the desired level of expenditures per program, then raise sufficient revenues to meet the targeted spending levels on an ongoing basis.
- Changes to the revenue system (such as reductions in tax rates and elimination of revenue sources) should be matched by a commensurate change in expenditures.
- Funding of new programs and changes in the funding level of existing programs should be matched by a change in revenues of a corresponding magnitude.
- Capital expenditures generally should not be paid out of the operating (general) fund.

Cyclical­ity of Public Revenues and Expenditures⁶

Across the nation, government revenue collections are more cyclical than the economy. Rates of growth in revenue collections are much higher during business expansions and much lower in recessions than growth rates in economic measures, such as personal income. The period of weakness in government revenue growth is longer than the period of slow economic growth.

⁶ Parts of this subsection were taken from Marshall Vest of the University of Arizona, Chapter 10 of the background report for the 95th Arizona Town Hall, *Riding the Roller Coaster: Government Revenue in Arizona*, November 2009 (<http://www.aztownhall.org/>).

Revenue cyclicality in Arizona is among the greatest in the nation, in part due to the high cyclicality of its economy and in part due to the structure of the revenue system. Revenues of the state general fund are especially cyclical, since 90 percent of the revenue comes from two highly cyclical sources: the income tax and sales tax.

Income tax revenues are especially volatile. Collections from the corporate income tax vary more widely over the economic cycle than from the individual income tax, but the volatility of the latter has increased since the mid-1990s—mostly due to realized capital gains fluctuating widely.

Until recent years, sales and use tax collections in Arizona were more cyclical than the economy but much less volatile than the income taxes. After an unusually high peak in 2006, sales and use tax collections have fallen sharply.

While government revenues rise and fall during the economic cycle, the overall demand for government services rises at a relatively steady pace throughout the business cycle. Demand for most services rises less rapidly during recessions, but the demand for some government services is countercyclical, rising more during recessions when people lose their jobs and qualify for government-provided healthcare benefits and welfare programs.

Thus, the cyclicality of revenues is not matched by a similar cyclicality in spending needs. This mismatch between available revenue and spending needs during recessionary periods is at the core of public finance issues.

A reduction in the state's economic cyclicality would reduce its public revenue volatility. However, economic diversification will do little to reduce the cyclicality of the Arizona economy or its public finance. The only way to substantially reduce economic cyclicality is to reduce the state's rate of population and business growth so that construction and real estate are not so important.

Revenue cyclicality can be reduced by widening the tax base and relying more on nontax sources, such as user fees. However, cyclicality cannot be eliminated. Thus, the key to managing government finances over an economic cycle is an adequately funded rainy-day fund (discussed in a later subsection).

Comparison of Fiscal Measures Over Time and Across States

In order to compare government finance data of states of widely varying sizes, and to compare data in one state over time as the population changes, the data must be adjusted. Two methods typically are employed to express the finance figures:

- Per capita (per person). If the per capita measure is used to look at data over time, it must be adjusted for inflation.
- Relative to some measure of the total size of the economy, such as gross product, adjusted gross income reported to the Internal Revenue Service, and personal income. The latter measure has been most widely used.

Both measures have significant limitations. Both can be used to compare government revenue or expenditure figures *for a given year*. Per capita analyses *over time* are *not* recommended.

Inflation-adjusted per capita incomes in the United States rise over time due to productivity gains by an average of close to 2 percent per year. In an increasingly affluent society, government tax collections per capita can increase without the tax burden increasing. Thus, over time it is important to consider changes in income when analyzing government finance data.

Comparative Tax Burden

The tax burden—typically expressed as the amount of taxes paid relative to income—is one of the most common measures of public finance. Evaluations of the tax burden from one state to another need to be done by combining state and local government taxes, since the level of government that levies taxes varies by state.

The Tax Foundation's estimate of tax burden uses alternative ways of expressing both taxes and income, with the income measure an improvement over the use of personal income. In 2008, Arizona's state and local government tax burden, combining business and personal taxes, was 8.5 percent of income compared to the national average of 9.7 percent. Arizona ranked 41st among the 50 states and the District of Columbia. Arizona's tax burden in recent years has been substantially less than in the past. Before 1980, the state's tax burden exceeded 10 percent and was higher than the national average. During the 1980s, the tax burden was between 9 and 10 percent, but was only a little less than the U.S. average.

A very different measure of tax burden is determined by calculating the amount of taxes that would be paid by a hypothetical household or business. The results can provide high-quality information for the hypothetical household or business but the findings should not be generalized to all households or businesses. Since this method is very labor intensive, few studies employ this approach and those that do limit their analyses to a small number of hypothetical businesses or households. The government of the District of Columbia produces such a study. It is limited to major taxes—income, sales, property, and various taxes/fees related to automobiles—for a three-person household that includes one child, but measures the results at five income levels.

The personal tax burden in Arizona in 2008 was substantially lower than in most states, ranking between 40th and 45th of the 51 'states' at each of the four income levels that range from \$50,000 to \$150,000. A family of three earning \$50,000 pays only \$3,000 in major state and local taxes. This is substantially less than the family's demands on the public sector; it costs more than this just to educate their child.

Ernst & Young estimates the amount of state and local government taxes paid by businesses. Relative to other states, businesses pay an above-average share of all taxes collected in Arizona. Overall, the business tax burden in Arizona, measured as a percentage of private-sector gross product, is near the national average and ranks among the middle of the states. The sales tax burden is high, the property tax burden is average, and each of the other business tax burdens is below the national average.

Though the overall business property tax burden is near the national average, a more in-depth look by the Minnesota Taxpayers Association reveals that the business tax burden on lower-value properties is relatively low, while the burden for higher-value properties, particularly those with a high percentage of personal property (such as equipment used by high-tech

manufacturers), is among the highest in the nation. Similarly, while the corporate income tax burden is shown to be below the national average, it is not nearly as far below average as the tax burden of unincorporated businesses that file using the individual income tax form.

Government Revenue or Expenditure Limitations

Traditionally, a measure that incorporates population growth, inflation, and real per capita economic growth, such as personal income, has been used to control the growth of government revenues or expenditures. For example, Arizona has a constitutional limitation on expenditures that is expressed as a share of personal income. The rationale is that if the growth rate of government revenues is equal to the economic growth rate, the tax burden remains steady. More recently, however, a push has been made by certain conservative groups to control government revenue and expenditure growth to simply inflation and population growth. Doing so causes government to shrink relative to the size of the economy and the number of residents, greatly restricting the ability of the public sector to respond to the demands of the populace.

Limiting revenues and expenditures to population and inflation means that government can only furnish the services that it currently provides. If another need appears, no revenue exists to pay for it. For example, governments could not have purchased computers when the technology became available, at least not without reducing existing services. Since health care inflation is much greater than overall inflation, health care services would have to be continually reduced—or funding would have to be reduced for other programs. In general, if the growth of government is restricted from keeping pace with economic growth, the quality and/or quantity of public services will continually lower over time.

Had a limitation of inflation and population growth been in place in 1912, when Arizona became a state, Arizona today would still look much as it did in 1912: dirt roads, schools without indoor plumbing or air conditioning, government records kept in handwritten ledgers, etc. What would now be considered Third-World conditions would have kept economic development in the state at Third-World standards, in turn causing the living standards of Arizonans to be similar to those of the undeveloped world.

Tax Rates and Government Revenues

Supply-side economics is based on the concept that tax rate reductions stimulate economic growth, with the stimulus so great that government revenue rises despite the lower tax rates. The “Laffer Curve” popularized this theory.

The economist Arthur Laffer brought the relationship between taxes and economic performance into the popular literature in the 1970s. However, the analytical foundations of his Laffer Curve were established centuries ago. Moreover, the curve is a mathematical relationship (Rolle’s Theorem).

The concept is simple. A single tax rate produces the greatest government revenue: the revenue-maximizing rate (RMR). Setting rates below the RMR leaves governments with less than maximum revenue but setting rates higher than the RMR stifles the economy, resulting in lower tax collections despite the higher rate. The relationship between tax rates and revenue collected follows a curve. The exact shape of the curve can vary by specific circumstances, but the end

points always are the same: No tax results in no public revenue while a 100 percent tax rate would cause all legal economic activity to cease. The difficulties in real-world application of this relationship are to identify the tax rate that constitutes the RMR, and to describe the exact shape of the curve.

Laffer originally discussed the relationship between tax rates and tax revenue in the context of national tax rates, particularly the federal income tax, which was quite high in the 1970s. The concept also is valid at a regional level such as a state. However, state tax rates are low relative to the federal income tax rate. Thus, a decrease in a state tax rate is less likely to have a supply-side effect and any effect likely is small.

On the other hand, a state tax by definition is narrower than a national tax and thus is more likely to have a RMR that is being exceeded in reality. This is because states compete for export-oriented economic activity, much of which is mobile (not tied to a particular place as in the case of a mine). Capital and labor move easily throughout the country.

While tax rates may influence capital and labor mobility across the states and give rise to Laffer-type effects, capital and labor move for a host of reasons. The amount and quality of public infrastructure (such as airports, roads, and schools) available in a region—amenities supported by state and local government tax revenue—are among the factors influencing economic growth. So the RMR in a state or region will be the rate that allows sufficient investment in public amenities that foster economic growth without imposing tax burdens that stifle growth.

For a tax cut to result in a positive effect on economic growth and government revenue, the existing tax rate must be higher than the RMR. For much of a positive effect to result, the tax rate must be very high and be lowered to near the RMR. Such a situation is most likely in the case of a narrow tax. In addition, a much greater economic impact is likely from a reduction in a business tax with a rate above the RMR than in a personal tax with a high tax rate. In particular, the business tax being lowered must be of significant importance to export companies.

Over time, some supply-side enthusiasts have moved to a position that any tax cut is good for the economy and enhances public revenue—which violates the Laffer Curve. Further, the idea that lower taxes always are better ignores the reality that taxes are the price paid for public services demanded by businesses.

Empirical evidence exists that public infrastructure plays a role in increasing business investment, job creation, and economic growth. Similarly, tax reductions financed by cutting education, infrastructure spending, and other services valued by businesses likely will have a negative effect on economic performance.

One argument sometimes used to justify tax reductions is that taxes remove money from the economy. In reality, tax revenue is spent in much the same way as private-sector revenue: paying employees, purchasing materials from the private sector, etc. On average, a higher portion of public-sector spending is for wages and salaries while private-sector firms spend a higher portion of their revenue on raw materials and manufactured goods, much of which must be purchased from outside the region. Because of this, public-sector expenditures stay within the state's

economy to a greater extent than private-sector expenditures. In other words, the in-state multiplier effect is higher for public-sector spending than for private-sector spending.

Tax Reductions in Arizona

A policy of state government tax reductions has been present in Arizona since the early 1990s. Most of the tax cuts, particularly during the 1990s, have been made to individual tax rates that already were less than the national average and lower than the historical rates in Arizona. Thus, based on the Laffer Curve, Arizona was not generally in a position to benefit from this series of tax cuts, either in terms of enhanced government revenue or economic performance. Further, little tax relief was granted to businesses, though the tax burden for some businesses is higher than the national average.

For a *net* positive effect to accrue on government finance from a tax cut, underutilized resources must be present. For example, if a state with higher-than-optimal tax rates also has high unemployment and high commercial and industrial vacancy rates, then a reduction in taxes to near the optimal point might stimulate economic growth, putting more residents to work and more highly utilizing existing facilities. Since labor to support the faster economic growth would not have to be imported to the state, population growth would not accelerate. Thus, the increase in government revenue realized from new economic activities would not be offset by the need to increase public spending to support new residents.

Except during recessions, Arizona has had neither high unemployment rates nor high commercial/industrial vacancy rates. Many of the jobs created in Arizona are filled by labor imported into the state from other states and other countries. Thus, even assuming that tax cuts in Arizona did have an effect on economic growth, the requirement of excess capacity was not met in order for a net benefit to government finance to accrue. If lowered taxes had stimulated the Arizona economy, then even more labor would have had to have been imported into the state, both for the construction of the facilities needed to house these economic activities and for the permanent employment created. Thus, while public revenue would have increased, the need for public spending also would have risen. Unless the incomes of the imported workers were above the existing average (considerably so if the worker had or would have school-age children), the taxes paid by new residents would not have covered the costs of providing them with public services.

Most of the taxes cut in Arizona since the early 1990s have been broad-based taxes applied to individuals. In particular, decreases in the individual income tax have accounted for nearly 60 percent of the cumulative \$1.6 billion nominal overall tax decrease since 1992. However, even in the early 1990s, the individual income tax rate in Arizona was less than the average of the states. Using the Laffer Curve, this suggests that the individual income tax cuts in Arizona should have decreased, not increased, government revenue. Conceptually, it is unlikely that these tax cuts had much of an effect on the state's economic performance.

Thus, the size, nature, and timing of the tax cuts in Arizona, combined with the conceptual basis for supply-side economics, suggest that little positive effect either on government revenue or on economic growth should have occurred as a result of these cuts. An empirical analysis confirms this conclusion. Despite the significant changes, up and down, in Arizona's tax burden relative to

other states since the late 1970s, economic growth in Arizona relative to the nation has not fluctuated. In particular, the substantial tax decreases since the early 1990s have not caused Arizona's economic growth in recent years to be stronger relative to the national average than in the past.

Just as an effect on economic growth from tax changes in Arizona is not perceptible, a comparison of changes in tax laws and changes in tax revenues fails to demonstrate a supply-side effect on revenues. In fact, tax cuts have resulted in revenue reductions and tax increases have boosted revenues.

The Current General Fund Budget

The existing state government general fund budget, as of early January 2010, is summarized in Table 1. Only ongoing revenues and expenditures—those excluding one-time transfers and other maneuvers—are shown.

The most notable feature of the revenue system is the very high dependence on just two revenue sources that account for nearly 90 percent of all revenue: the sales and use tax and income taxes, particularly the individual income tax. A high proportion of the spending also goes to a limited number of programs. Education accounts for 60 percent of the expenditures, health and welfare for 24 percent, and protection and safety 11 percent.

Deficits

Any discussion of public-sector fiscal deficits is complicated by differing definitions of terms and the multiple ways of calculating a deficit. In general terms, a deficit occurs when revenues are less than expenditures.

Discussions of deficits usually refer to the expected deficit during the current fiscal year and/or to predicted deficits in following years. Thus, the size of the deficit is dependent on projections of both revenues and expenditures; estimates of the size of the deficit may vary from one analyst to another.

Since early 2008—when the onset of the latest recession and the implementation of the last substantial tax cut caused revenues to decline—discussions of the state budget have been dominated by the large total deficit in the general fund. The Governor's Office of Strategic Planning and Budget (OSPB) and the Joint Legislative Budget Committee (JLBC) differentiate between two types of deficits. They call the deficit between ongoing revenues and ongoing expenditures a "structural" deficit. This deficit is synonymous with the total deficit between ongoing revenues and ongoing expenditures. The JLBC estimates the size of this deficit at \$3.5 billion in the current year; the OSPB estimate is somewhat larger.

The magnitude of this "structural" deficit varies by year due to the economic cycle; the JLBC projects a somewhat smaller deficit of \$3.2 billion in fiscal year 2011, largely due to an expected cyclical rebound in revenues. The OSPB and JLBC each expect a very large deficit to remain in coming years. However, this is based on a very conservative economic outlook—one in which the economy and public revenues recover extremely slowly from the recession that is just

TABLE 1
ARIZONA GENERAL FUND, FISCAL YEAR 2010*

	Dollars in Millions	Share of Total
ONGOING REVENUES	\$6,392	100.0%
TAXES	6,152	96.2
Sales and Use	3,481	54.5
Income	2,191	34.3
Individual	2,391	37.4
Corporate	429	6.7
Urban Revenue Sharing	-629	-9.8
Property	20	0.3
Luxury	59	0.9
Insurance Premium	397	6.2
Other Taxes	3	0.0
NONTAX	240	3.8
Lottery	36	0.6
Licenses and Fees	137	2.1
Disproportionate Share Revenue	68	1.1
 ONGOING EXPENDITURES	 8,993	 100.0
EDUCATION	5,438	60.5
Department of Education	4,256	47.3
School Facilities Board	113	1.3
Community Colleges	135	1.5
Universities	902	10.0
Other	32	0.4
HEALTH AND WELFARE	2,189	24.3
Arizona Health Care Cost Containment System	1,178	13.1
Department of Economic Security	546	6.1
Department of Health Services	444	4.9
Other	21	0.2
PROTECTION AND SAFETY	999	11.1
Department of Corrections	880	9.8
Department of Juvenile Corrections	63	0.7
Department of Public Safety	44	0.5
Other	12	0.1
INSPECTION AND REGULATION	33	0.4
NATURAL RESOURCES	45	0.5
GENERAL GOVERNMENT	289	3.2
Courts	120	1.3
Department of Revenue	38	0.4
Legislature	52	0.6
Other	79	0.9

* Revenues reflect projections made in early January 2010 by the authors. Expenditures, as reported by the Joint Legislative Budget Committee, reflect the adjustments to the original appropriations made during the fourth and fifth special sessions of the Legislature.

ending. Consistent with this pessimistic outlook, spending demands related to welfare programs continue to rise in the JLBC, and especially the OSPB, forecasts.

A more moderate economic forecast is assumed in this *Roadmap*. Economic growth is expected to be slow for a couple of years, then accelerate substantially, similar to past recoveries. However, the size of the total deficit in the current fiscal year is estimated to be larger than the shortfalls estimated by the JLBC and OSPB. A \$4.0 billion deficit has been estimated, based on projected ongoing revenue of \$6.4 billion and expenditures of \$10.4 billion. This expenditure figure assumes that baseline spending per \$1,000 of personal income is that of the original fiscal year 2008 budget—before the onset of the recession, which caused revenues to fall and resulted in reductions in spending in an attempt to balance the budget. Spending per \$1,000 of personal income in fiscal year 2008 is then increased to reflect the countercyclical increases in demand for AHCCCS and other welfare programs. The apparent deficit from Table 1 of \$2.6 billion in FY 2010 is based on the same projected ongoing revenue of \$6.4 billion but reflects the actual budgeted ongoing expenditures of only \$9.0 billion. Effective spending reductions of \$1.4 billion have already been put in place.

The second deficit defined by the OSPB and JLBC is the budget deficit in the general fund that remains after one-time efforts to resolve the structural deficit in any year. Because of the use of fund transfers, federal government stimulus monies, revenues from the sale-leaseback of state facilities, and spending reductions, the overall deficit in the current year has been reduced to between \$1.4 billion (OSPB) and \$1.5 billion (JLBC).

The total deficit can be divided into two portions. A “cyclical” deficit is a temporary deficit during an economic downturn largely due to a cyclical decline in revenue (but also due to a countercyclical increase in demand for certain public services). A “persistent” deficit is due to a fundamental imbalance between revenues and expenditures that does not vary with the economic cycle. The persistent portion of the deficit is more accurately termed a “structural” deficit, but because the OSPB and the JLBC give this term a different meaning, “persistent” is used in this report.

Persistent Deficit. A persistent deficit is caused by permanent reductions in revenues not adequately matched by reductions in expenditures and/or by adding spending obligations without raising a commensurate amount of revenue. Barring further actions, a persistent deficit will remain as a constant share of the total budget. Alternatively, a persistent deficit can be thought of as the average total deficit over the course of an entire economic cycle, in which cyclical deficits and surpluses net to zero. The federal government, which does not have a requirement to balance revenues and expenditures, has such a persistent deficit.

Arizona created a persistent deficit in the state government general fund in the late 1970s and early 1980s when various revenue sources were reduced without a compensating decrease in spending. That persistent deficit was briefly resolved when tax revenues were increased and spending was reduced in the late 1980s. However, a new persistent deficit was introduced in the early 1990s when tax cuts were initiated without an adequate reduction in expenditures to offset the loss of revenue. The size of the persistent deficit has continued to grow through the current time due to a long series of tax cuts being implemented—even in 2009, modest reductions in

revenues were passed by the Legislature—and due to new spending demands being added to the general fund without a revenue source. Though expenditures for some programs have been reduced relative to the size of the economy since the early 1990s, the reductions were not nearly large enough to offset the lost revenue and the increased spending requirements in other programs.

A large persistent deficit in the state's general fund is present despite a constitutional requirement to annually balance the budget. During economic expansions, the cyclical surplus has exceeded the persistent deficit. During economic downturns, the total deficit has been temporarily resolved largely through one-time corrections, such as transfers into the general fund from the rainy-day fund and other state government funds, and through reductions in expenditures.

The size of the persistent deficit in the state's general fund is estimated to be \$2.2 billion in the current fiscal year and \$2.3 billion in the next fiscal year. The increase in size is largely the result of the expanding size of the budget, though modest tax cuts continue to be implemented as well. With no further actions being taken, the persistent deficit could reach \$2.9 billion in fiscal year 2015.

The magnitude of the persistent deficit was estimated as follows. Historically, general fund revenues and expenditures averaged a little more than \$49 per \$1,000 of personal income. The tax reductions passed since the early 1990s have totaled nearly \$1.7 billion before adjustment for population growth, inflation, and real per capita economic growth. After these adjustments, the value of the tax reductions in the current fiscal year reaches nearly \$3 billion, or close to \$14 per \$1,000 of personal income. Using the originally budgeted appropriations for fiscal year 2008—the latest figures before the recession began—expenditures had fallen close to \$4 per \$1,000 of personal income from the long-term average. Thus, despite the additional spending obligations added to the general fund for school construction, expansion of AHCCCS, and other programs, net spending had fallen. The \$10 greater decline in revenues than expenditures per \$1,000 of personal income equates to a \$2.2 billion persistent deficit in the current fiscal year. (If it is assumed that the spending reductions made since 2008 are permanent, then the size of the persistent deficit has been substantially reduced.)

Cyclical Deficit. All governments experience cyclical imbalances between revenues and expenditures due to the cyclicity of revenue streams being greater than the cyclicity of economic growth, and because of the countercyclicity of some demands on the public sector. During economic expansions, the cyclical fiscal imbalance takes the form of a surplus. During economic recessions, the cyclical imbalance between revenues and expenditures takes the form of a deficit.

Government fiscal surpluses nearly always are temporary. Neither permanent spending increases nor permanent tax reductions should be implemented on the basis of a temporary surplus. Instead, cyclical surpluses should be saved to be used to mitigate the inevitable cyclical deficits that will follow. Utilizing savings to offset a loss of revenue during a recession means that neither spending reductions nor tax increases—both of which have a negative effect on the economy—are necessary during an economic downturn.

The cyclical deficit is estimated to be about \$1.8 billion (total deficit of \$4.0 billion less the persistent deficit of \$2.2 billion) in the current year. This is the largest cyclical deficit of this down cycle. The cyclical deficit will shrink over the next few years, then become a cyclical surplus. However, the persistent deficit has grown so large that cyclical surpluses will not be large enough to eliminate the total deficit in the upcoming economic expansion even with the strong projected economic growth assumed in this *Roadmap*.

Protected Spending

Significant portions of the general fund, and portions of other state government funds, currently are “protected” from spending reductions. The protection takes two forms.

Proposition 105, passed in 1998 by the voters, specifies that the Legislature cannot amend statutory language in ballot propositions unless the amendment “furthers the purposes” of the proposition and is approved by at least a three-fourths vote of the Legislature. The exact amount of spending that is protected is subject to legal interpretation. In a December 2008 memo, the JLBC estimated that \$3.6 billion of the then \$10 billion general fund was protected, with an additional \$1.2 billion of spending from other funds protected. A high percentage of the voter-protected spending is for the Arizona Department of Education and for the Arizona Health Care Cost Containment System (AHCCCS), Arizona’s alternative to the Medicaid program that provides health care for low-income individuals and people with certain disabilities.

In addition to this voter-stipulated “permanent” protection from spending cuts, a large portion of the general fund is currently temporarily protected from spending reductions due to the American Recovery and Reinvestment Act (ARRA), the stimulus program of the federal government that was passed by Congress in February 2009. By accepting the ARRA monies, the state is mandated not to reduce spending in certain programs below specific levels, effectively protecting a significant portion of the general fund in FYs 2010 and 2011. OSPB estimates that only \$2.4 billion of the \$9 billion general fund is currently unprotected, with most of the unprotected portion in the correctional system or in general government. The unprotected amount is expected to rise to \$3.4 billion in FY 2011 as ARRA funding begins to drop.

Rainy-Day Fund⁷

In the private sector, an economic slump reduces demand for goods and services. The drop-off in sales leads to a general reduction in business activity, frequently resulting in layoffs of personnel no longer needed. In the public sector, however, demand for most public functions does not decline and demand for some programs rises countercyclically. Government revenue collections, however, are highly cyclical, falling during economic downturns.

Therefore, it is especially important for the public sector to have funds set aside to offset revenue decreases during an economic decline. In order to minimize the need to enhance revenue and/or reduce spending during an economic downturn, all states have adopted a rainy-day fund, generally known as a budget stabilization fund (BSF). Continued public spending during a

⁷ Parts of this subsection were taken from Alberta Charney of the University of Arizona, Chapter 17 of the background report for the 95th Arizona Town Hall, *Riding the Roller Coaster: Government Revenue in Arizona*, November 2009 (<http://www.aztownhall.org/>).

recession using BSF monies helps mitigate the impact of a recession. When the economy is strong, use of a rainy-day fund helps control public expenditures by setting aside, rather than spending, excess revenue.

Arizona has had a BSF since 1990. However, it has been modified and weakened in various ways since it was first created. The BSF was originally designed to hold as much as 15 percent of the general fund budget, with payments into and out of the fund dictated by a formula. This formula was modified, the 15 percent cap was lowered to 7 percent, the formula was not followed, and certain expenditures were made from the BSF for purposes other than revenue stabilization. In particular, the reduction in the maximum size of the BSF has resulted in far too little money being put aside to balance the budget during each of the two recessions that have occurred since the BSF was created.

Fiscal Stimulus

An increase in government spending, all else equal, results in a short-term economic stimulus. Increased federal government spending during a recession, as exemplified by the stimulus package passed in 2009, is commonly used, usually with the express purpose of putting unemployed workers back into a job. The cost of doing so is to raise the size of the federal deficit.

It is more difficult for state and local governments to stimulate the local economy because of the annual requirement to balance the budget. This effectively limits the ability of state and local governments to combat deficits and economic ills resulting from cyclical factors. State and local governments can stimulate the economy in the near term only through long-term borrowing, which raises government costs in the longer term due to the debt service.

Just as an increase in government spending produces a short-term economic stimulus, a decrease in public spending has a detrimental short-term impact on the economy. Thus, if state and local governments reduce spending in order to offset a cyclical deficit, this worsens economic conditions during a recession, in turn lowering government revenues even more. An increase in taxes or user fees to combat a cyclical deficit also has a negative effect on the economy, but the ramifications are smaller than if spending is reduced. This is primarily due to some taxpayers being able to pay the additional taxes out of savings rather than by reducing their spending in the private sector. Of course, the best solution to a cyclical deficit is to have enough rainy-day funds set aside.

Using an estimated \$1.4 billion in effective spending reductions in the general fund over the last three years, the result likely has been a loss of nearly 31,000 jobs in Arizona (based on the REMI economic model). About 45 percent of these job losses have occurred in the private sector. If all of the current \$2.2 billion persistent deficit were to be resolved through spending reductions, the likely result would be the loss of about 48,000 jobs in Arizona.

A reduction in government spending is accomplished through some combination of reduced direct expenditures for goods and services purchased from the private sector, reductions in wages of government employees, layoffs of government employees, and reductions in support for public welfare and health care recipients. All of these methods result in less business for local

private-sector companies. As a result, some private-sector companies are forced to lay off employees, and in extreme cases, some businesses fail. In turn, laid-off workers pay less in taxes to state and local governments, and place greater demands on public services, such as unemployment compensation.

An Evaluation of Arizona's Fiscal System

Arizona's fiscal system does not compare favorably to the fiscal guiding principles. The existing very large budget deficit—and the large deficit in the prior recession—is the primary manifestation of the state's fiscal shortcomings. While the overall deficit is in part a result of cyclical economic conditions, the majority is due to a persistent deficit of \$2.2 billion. The single largest cause of the persistent deficit is the nearly \$3 billion in tax cuts passed since the early 1990s (after adjusting the initial effect of the tax cuts for inflation, population growth, and real per capita economic growth). Additional spending obligations placed in the general fund, such as paying for school construction and expansion of the Medicaid (AHCCCS) program, contributed to the build-up of the persistent deficit. Other contributing factors include revenue growth slower than economic growth and increases in the demand for public services. The negative effects of these factors on a balanced budget were partially offset by restricting growth in appropriations for some programs, such as higher education, to less than economic growth.

Arizona's fiscal system is poorly rated for three reasons. First, the principle of accountability—that revenues and expenditures should be linked—has been violated repeatedly since the early 1990s (and numerous times prior to that, especially in the late 1970s and early 1980s). Tax cuts were time and again made unaccompanied by a commensurate amount of spending reductions. Spending obligations were added to the general fund without a revenue source. Particularly egregious was the shifting to the general fund of the responsibility for school construction—expenditures of several hundred million dollars per year for capital projects that should be financed through long-term debt—without any revenue added to the general fund. The result of the repeated violation of this principle is the large persistent deficit faced by the state today.

Second, the weakening of the budget stabilization fund left the state unable to counter the strong cyclicity of the Arizona economy that creates revenue reductions and increases in demand for state services when the economy is weak. The result was a substantially inadequate balance in the BSF to offset the cyclical declines of each of the two recessions since the creation of the BSF.

Given that the length and depth of the current recession has not been seen since the depression of the 1930s, even a BSF with a 15 percent balance would not have been adequate to entirely offset the cyclical deficit that appeared in consecutive years. However, a BSF balance of 15 percent coupled with no persistent deficit would have left a deficit manageable through the use of some of the one-time options that have been used to combat the much larger deficit actually experienced.

Third, the state's revenue system (state and local government revenues combined, but with a heavy emphasis on state taxes) falls short on most of the 10 principles specific to revenues. A qualitative assessment was made of how well each of Arizona's larger tax sources currently compare to each of the guiding principles. A weighted sum (based on share of total revenue contributed by each source)

of these evaluations resulted in the qualitative assessment of the overall system shown in Table 2. Arizona’s current revenue system receives a poor evaluation relative to a system of best practices on most of the guiding principles: stability, predictability, responsiveness, efficiency, competitiveness, neutrality, horizontal equity, vertical equity, and simplicity.

No revenue system can be designed to excel in all criteria since some of the guiding principles partially conflict with others. However, a much-improved system could be created by applying generally accepted best principles of revenue policy to Arizona’s system. A system that achieves an OK-to-good evaluation against each of the guiding principles is feasible to create.

Tables 3 through 6 provide a qualitative assessment of each of the four major tax sources used by state and local governments. The general sales tax currently compares least favorably and has the greatest potential for improvement. In contrast, there is not much room for improvement in the individual income tax.

A modification of the current mix of revenue sources would put the state’s revenue system more in line with a best-practices revenue system. Some tax bases would be broadened. Some tax rates would be increased but other tax rates would be decreased. In making such changes, experts agree that the revenue system as a whole, not as a set of unrelated components, be examined. The ideal system would look essentially the same regardless of the desired amount of revenues to be collected. Total revenues could be raised or lowered by adjusting tax rates and user fees throughout the system.

In addition, strengthening the budget stabilization fund by increasing the amount that can be placed into the fund and by making transfers to and from the fund strictly formula driven, not subject to appropriation, would greatly enhance stability and predictability of revenue flows. Except during severe recessions, cyclical deficits could be offset by funds from the BSF.

**TABLE 2
A QUALITATIVE ASSESSMENT OF THE OVERALL REVENUE SYSTEM
AS CURRENTLY STRUCTURED IN ARIZONA**

Guiding Principle	Evaluation*	Comments
Stability and Predictability	Poor	Highly cyclical revenues, multiple changes to tax code, poor use of rainy day fund, overemphasis on sales tax, little use of more stable revenue sources
Responsiveness	Poor	Overemphasis on sales tax, whose collections lag behind economic growth due to out-of-date tax code
Efficiency	Poor	Heavy reliance on certain taxes, some with high tax rates
Competitiveness	Poor-to-OK	Heavy taxation of businesses, particularly on the property tax (though some business tax reductions have been passed in recent years)
Exportability	Good	Some of the tax burden is borne by nonresidents
Neutrality	Very Poor	Multiple tax credits and exemptions
Horizontal Equity	Poor	Credits and exemptions are a negative
Vertical Equity	Poor	Heavy and increasing reliance on regressive taxes
Simplicity	Very Poor	Considerable complexity in the tax code of each of the major taxes

Another way of looking at the problems of the revenue system is to examine revenues over time per \$1,000 of personal income, focusing on the state government general fund. Through the mid-1990s, ongoing revenues (total revenue excluding one-time shifts of funds) averaged just less than \$50 per \$1,000 of personal income. That is, nearly 5 percent of personal income was paid to the state government general fund to support public education (K-20), public safety, health and welfare programs, and a host of other state government services.

Ongoing revenue per \$1,000 of personal income has trended down since the mid-1990s (see Chart 1). This decline is largely due to the long series of tax cuts implemented since then, but revenue collections have not kept pace with economic growth due to the heavy reliance on the sales tax. The narrow base of the sales tax on nonfood goods ensures that it will not produce revenues that keep pace with economic growth as consumers continue to shift their purchases to untaxed services and untaxed goods purchased over the Internet.

In addition to the downward trend, ongoing revenues have been highly cyclical over the last decade. Even at the peak of the last economic expansion in FY 2006, during the real estate boom, ongoing revenues per \$1,000 of personal income did not reach the long-term norm. Ongoing

**TABLE 3
A QUALITATIVE ASSESSMENT OF THE GENERAL SALES TAX IN ARIZONA**

Guiding Principle	Evaluation*	Comments
As Currently Structured		
2. Stability and 4. Predictability	Poor	Limited to nonfood goods
3. Responsiveness	Poor	Services and Internet not taxed
5. Efficiency	Poor	High tax rate on narrow base; across jurisdictions, lack of standardization causes distortions
6. Competitiveness	Poor	High tax rate
7. Exportability	Good	
8. Neutrality	Poor	Large number of exemptions
9. Horizontal Equity	Poor	Exemptions reduce equity
10. Vertical Equity	Poor	Highly regressive
11. Simplicity	Poor	Differing rates, bases, and exemptions/credits across state and local governments
As Potentially Improved		
2. Stability and 4. Predictability	OK	Broaden base to include Internet sales, food, and many services
3. Responsiveness	OK	Broaden base
5. Efficiency	Good	Lower tax rate on broader base; streamline code
6. Competitiveness	OK	Lower tax rate
7. Exportability	Good	
8. Neutrality	Good	Reduce exemptions
9. Horizontal Equity	Good	Reduce exemptions
10. Vertical Equity	OK	Broaden base, offer tax credit
11. Simplicity	Good	Simplify tax code

* Relative to a system of best practices.

revenues have plummeted since then, largely due to the length and depth of the economic recession, but also as a consequence of the most recent tax reductions. A very large decrease in personal income taxes was phased in during fiscal years 2007 and 2008.

General fund revenues have fallen far more than incomes during this economic recession, such that revenues in FYs 2009 and 2010 account for only about 3 percent of Arizona income, instead of the historically typical 5 percent. Even after adjusting for the negative effects on income from the recession, the state government tax burden borne by Arizonans is now by far the lowest in the state's history. Thus, Arizonans in aggregate have the means to pay far more in public revenue than they are being asked to contribute.

Ongoing expenditures have to be relatively consistent with ongoing revenues due to the state's balanced budget requirement. However, as seen in the chart, the two lines can differ due to one-time actions taken to balance the budget. Like ongoing revenues, ongoing expenditures have been consistently well below the historical norm of about \$49 per \$1,000 of personal income since the mid-1990s (except for a figure near \$49 in 1999) and have been highly cyclical over the last decade.

TABLE 4
A QUALITATIVE ASSESSMENT OF THE PROPERTY TAX IN ARIZONA

Guiding Principle	Evaluation*	Comments
As Currently Structured		
2. Stability and 4. Predictability	Usually Good	Generally not very cyclical, but exaggerated real estate cycles have occurred in recent years
3. Responsiveness	Good	Property values rise with real economic growth
5. Efficiency	Poor	Property taxes on businesses are high
6. Competitiveness	Poor	High business taxes, particularly tax on equipment
7. Exportability	OK	Out-of-state property owners are taxed
8. Neutrality	Poor	Different rates by category of property
9. Horizontal Equity	OK	
10. Vertical Equity	OK	A mix of progressive and regressive elements
11. Simplicity	Very Poor	Multiple rates, assessments; varies by jurisdiction
As Potentially Improved		
2. Stability and 4. Predictability	Good	Reinstate the property tax for the state general fund
3. Responsiveness	Good	
5. Efficiency	OK	Lower the tax burden on businesses
6. Competitiveness	OK	Reduce commercial/industrial assessment rates; reduce/eliminate business personal property tax
7. Exportability	OK	
8. Neutrality	Good	Standardize assessment rates
9. Horizontal Equity	Good	Standardize assessment rates
10. Vertical Equity	OK	
11. Simplicity	OK	Many simplifications possible

* Relative to a system of best practices.

TABLE 5
A QUALITATIVE ASSESSMENT OF THE PERSONAL INCOME TAX IN ARIZONA

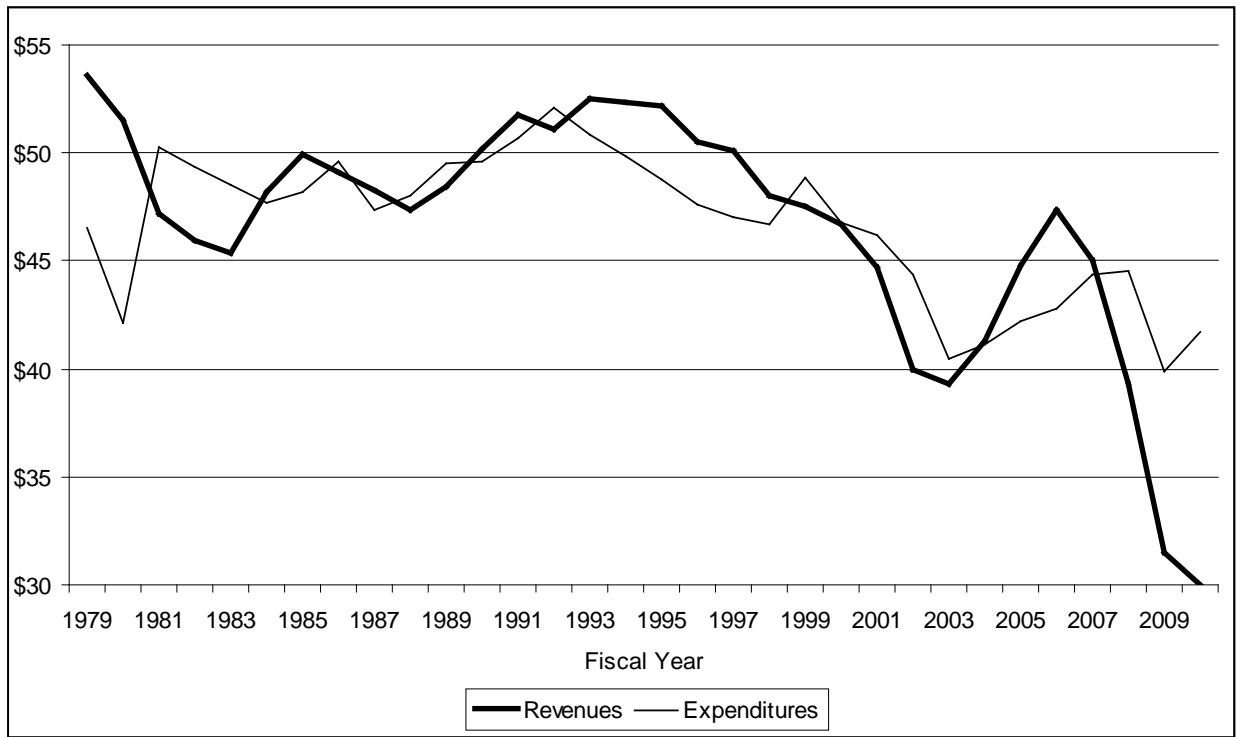
Guiding Principle	Evaluation*	Comments
As Currently Structured		
2. Stability and 4. Predictability	Poor	Cyclical
3. Responsiveness	Good	
5. Efficiency	Good	
6. Competitiveness	Good	Low tax burden
7. Exportability	Poor	Applies only to those earning income in Arizona
8. Neutrality	Poor	Many credits
9. Horizontal Equity	OK	
10. Vertical Equity	Good	But not as progressive as in many states
11. Simplicity	Poor	Mostly resulting from the complex federal code
As Potentially Improved		
2. Stability and 4. Predictability	Poor	
3. Responsiveness	Good	Index tax brackets
5. Efficiency	Good	
6. Competitiveness	OK	
7. Exportability	Poor	
8. Neutrality	OK	Reduce use of exemptions and credits
9. Horizontal Equity	OK	
10. Vertical Equity	Good	Modify tax rates and brackets to raise progressivity
11. Simplicity	Poor	

TABLE 6
A QUALITATIVE ASSESSMENT OF THE CORPORATE INCOME TAX IN ARIZONA

Guiding Principle	Evaluation*	Comments
2. Stability and 4. Predictability	Very Poor	Highly cyclical
3. Responsiveness	Good	
5. Efficiency	OK	
6. Competitiveness	OK to Poor	OK relative to all states, poor versus comparison states
7. Exportability	OK	
8. Neutrality	Poor	Multiple credits and exemptions
9. Horizontal Equity	Poor	Because of exemptions/credits
10. Vertical Equity	Poor	Only one tax bracket
11. Simplicity	Very Poor	Complex code; some companies avoid paying tax

* Relative to a system of best practices.

CHART 1
ONGOING REVENUES AND EXPENDITURES PER \$1,000 OF PERSONAL INCOME,
ARIZONA GENERAL FUND



Note: The FY 2010 figures reflect projected revenues as of January 2010, appropriations adjusted for the reductions passed in the special sessions in fall 2009, and projected personal income.

Note: If an economic measure other than personal income were used to adjust revenues and expenditures, the pattern of the lines in the chart would essentially be the same.

Source: Arizona Joint Legislative Budget Committee and Arizona State University, Office of the University Economist.

Much attention has been given to the rise in expenditures between 2003 and 2008. This increase, however, came from an all-time low. Even at the peak, ongoing expenditures per \$1,000 of personal income were less than \$45: nearly 10 percent less than the historical norm. Thus, no justification exists for claims that abnormally high spending in the mid-2000s caused the state’s current fiscal difficulties.

Expenditures have not yet dropped as much as revenues in the current recession due to the one-time adjustments made and due to the amount of spending protected by voter initiative and/or the federal stimulus program. Of course, a \$1.5 billion deficit remains to be resolved. Still, the spending figures per \$1,000 of personal income in FYs 2009 and 2010 are among the lowest on record, along with the figures during the last recession.

SCENARIO 1: INACTION

This section examines Arizona's future if no substantive action is taken to deal with the state's economic and fiscal problems.

Job Creation: Nature and Timing of Economic Recovery in Arizona

At the end of 2009, the Arizona economy was just beginning to recover from its longest and deepest downturn since the 1930s. After experiencing little or no loss of employment during the previous several recessions, Arizona lost 275,000 jobs—10 percent of its wage and salary workers—between late 2007 and late 2009.

While the Arizona economy recovered rapidly from some of its prior recessions, such as in 1983, the recoveries from each of the last two recessions were much slower. Given the extent of the real estate problems still to be resolved, the upcoming recovery is likely to be even slower. Modest economic growth is expected through 2010 and 2011. Growth should then accelerate, but the peak job level of 2007 is not expected to be reattained until 2014.

Economic growth is unlikely to be as strong in the upcoming expansion as in the last two. The very fast growth in those cycles should be viewed as aberrations. The booms in the stock market during the 1990s and in the real estate market in 2004 and 2005 were driven by the large number of Americans born during the baby boom (1946 through 1964), who had relatively high earnings and savings coupled with a willingness to assume risk. Since the baby-boom generation is now nearing retirement, these individuals likely will become more cautious in their investment strategies and therefore may not drive a temporary boom during the next economic expansion. If a boom does not develop, the temporary surges in public revenues that caused budget surpluses in Arizona during the mid-to-late 1990s and mid-2000s will not recur.

The other reason to expect slower growth than in the two prior expansions is that the number of immigrants moving to Arizona should be far lower than it was between the mid-1990s and mid-2000s. During the 1990s, young Americans aging into the workforce were comparatively few in number, a result of the lower number of births during the 1970s. There were not enough Americans to fill all of the jobs being created, providing the opportunity for immigrants to move to the United States. This influx stimulated economic growth further.

Many more Americans now are aging into the workforce due to the sizable increase in the number of births during the 1980s, reducing job opportunities for immigrants. In addition, Mexico's demographics are changing; fewer Mexicans will need to leave the country to find work. In Arizona, the employer sanctions law likely will be the most important factor limiting undocumented immigration. Thus, slower population growth and lesser employment growth are likely in Arizona in coming years relative to the period from the mid-1990s through the mid-2000s.

Economic Competitiveness

Arizona's fast growth, other than during recessions, is an indication that its export base is growing quickly despite the state's economic competitiveness not being rated as a strength. (Evaluations of the state's business climate range from good to poor.) It is likely that Arizona's natural attractions—including climate, open spaces, and lifestyle—continue to offset its

weaknesses, at least for some types of base economic activities. However, the state's subpar job quality, with no improvement occurring over time, is a sign that these natural attributes are not enough to compensate for its shortcomings among the key base industries.

Ignoring for the moment the state's fiscal problems, the state should continue to grow for a long time even if positive actions to improve economic competitiveness are not undertaken. Of course, the quality of the growth will remain a concern, as will the high cyclical nature of the economy.

The possibility of not reversing the spending reductions already made over the last two years and of substantial further reductions in public expenditures clouds this outlook. Reductions in some public programs have more of an effect on economic competitiveness and economic development than others. Reductions in programs—education, job training, and provision and maintenance of infrastructure—important to the key base industries will have serious long-term consequences.

Within the general fund, reductions in spending for education likely will have the most serious negative consequences on economic development. Yet education accounts for 60 percent of the general fund, so it is difficult to conceive of balancing the budget primarily through spending cuts without a significant reduction to education funding.

Reductions in spending in the K-12 system are likely to result in a greater proportion of students unprepared to pursue higher education and unprepared to compete for jobs in the 21st-century economy. Spending reductions for higher education not only would reduce the quality of the education offered, but could result in a lesser number of students pursuing higher education due to the likely increases in tuition that would result. The lowering in workforce quality from reductions in K-12 and higher education spending likely would end any pretense the state has of attracting the key base industries.

The other aspect to producing a quality workforce consists of job training. It is hard to imagine improving the existing system without an infusion of additional funds—that will be unavailable given the current revenue system.

Other than K-12 school construction, infrastructure maintenance and repair is largely funded from outside the general fund. However, a state unwilling to pay for basic general fund services such as education is not likely to have the willingness to commit enough funds to provide a quality infrastructure. A deteriorating infrastructure likely will have a significant negative effect on economic competitiveness.

Other than workforce/education and infrastructure issues, the other primary issue of concern to the state's economic competitiveness is the high tax burden borne by many export businesses and the shortage of incentives available to help attract high-quality employers. While the solution is obvious—reduce selected business tax rates and provide more funding for incentives—taking these actions will reduce public revenues, especially in the short term, forcing even larger spending reductions. Thus, business tax cuts could easily have a counterproductive effect, with

the negative effects of spending reductions for state services that are of value to employers more than offsetting the improvement in economic competitiveness from lower taxes.

Spending reductions for a few programs will have immediate negative effects on the economy. For example, if the state parks system is largely closed, tourism likely will suffer. Closed parks also could have a negative effect on retirement migration.

However, spending reductions for many programs will not have an immediately perceptible effect on the economy. For example, it takes more than a decade for a child to complete their K-12 education; a failure to spend adequately to maintain infrastructure does not result in the immediate deterioration of that infrastructure. Thus, spending reductions that have already gradually occurred in some programs over the last 15 years may only now be starting to have a significant negative effect. For example, general fund spending on the university system exceeded \$7.60 per \$1,000 of personal income every year through FY 1992. Since then, it has fallen, to less than \$5 in each year since FY 2004 and to less than \$4.30 in FYs 2009 and 2010: a decrease of more than 40 percent.

Thus, while it may appear that certain types of spending can be reduced without significant ill effects, it may simply be that the negative effects have yet to manifest themselves. When the problems do become apparent, it will be very difficult to reverse years of neglect in a short period of time—even if there is a strong desire to do so.

State Budget: An Assessment of Current and Future Conditions Absent Any Action

A large budget deficit of around \$1.5 billion remains in FY 2010. The loss of a substantial portion of federal stimulus monies—currently accounting for \$1.1 billion of revenue to the general fund—will cause a significant loss of revenue in FY 2011, with the remaining stimulus funding gone by FY 2012. The loss of revenue from this source largely will be offset by a cyclical rebound in ongoing revenues. However, given the large continuing increases in demand for public programs such as AHCCCS and food stamps, expenditures will need to be higher in FY 2011 than in the current fiscal year. Assuming no action is taken to balance the current year's deficit and that it rolls into FY 2011, and that the spending reductions made over the past two years continue, the deficit in FY 2011 likely will be approximately \$2 billion.

As the economy continues to cyclically recover, revenues will continue to rise and the countercyclical increases in demand for public programs will end. Thus, the size of the deficit will shrink. Depending on the strength of the next economic expansion, a surplus could even appear—temporarily. However, the needs will overwhelm the amount of any available surpluses: (1) the numerous temporary fund sweeps and accounting maneuvers used since 2008 will need to be reversed; (2) the balance in the BSF will need to be rebuilt, ideally to well beyond the current cap of 7 percent; (3) pressure will mount to restore funding to programs that have experienced spending reductions since FY 2008; and (4) additional spending pressures will be present. For example, the need to maintain existing infrastructure and build new infrastructure will be great, and costs will be high. Health care likely will continue to be an increasing burden, not only in terms of rising spending for AHCCCS but also for providing health insurance to public employees.

Even if the annual deficit briefly disappears, a new budget deficit will begin to grow as soon as the economy slows. This deficit will become very large as the economy slides into the next recession. To avoid such a chronic deficit, the remainder of the persistent deficit—nearly \$1 billion today—must be eliminated. This can be achieved only through a permanent increase in revenue and/or a permanent reduction in spending. Without revenue enhancements, another nearly \$900 million in permanent spending reductions on top of the \$1.4 billion that has effectively been cut already will amount to nearly one-fourth of the state’s budget in 2008.

Even if the persistent deficit is resolved through permanent fixes, significant cyclical budget deficits will recur during each succeeding economic down cycle. The funds placed in the budget stabilization fund, assuming the 7 percent cap remains, will be drained in virtually all downturns, necessitating fund sweeps, further spending reductions, and other maneuvers to balance the budget every several years.

Given the constitutional requirement to balance the budget, Arizona’s current budget deficit will need to be resolved. However, since the Arizona Constitution allows a deficit to be carried into the next year provided it is resolved that year, the resolution of the deficit need not occur in the next few months. Based on the assumption that there will continue to be no willingness to address the issue through revenue enhancements, or that any revenue enhancements will address only a portion of next year’s projected \$2 billion deficit, then a significant additional spending reduction will be needed.

The latest budget for FY 2010—after the reductions made during the two special sessions late in 2009—includes \$9 billion in general fund appropriations. This is \$1.1 billion (11 percent) less than the original budget for 2008. Incorporating the effects of inflation and increased demand for state services, the effective decrease is approximately \$1.4 billion.

Another way of looking at spending reductions is to compare the final budget for each year to the original appropriations. The reductions were \$203 million in FY 2008, \$1,183 million in FY 2009, and \$368 million so far in FY 2010. The sum of mid-year reductions over the three years is \$1.75 billion. Using a different accounting, the OSPB counted a spending decline of \$1 billion in just FYs 2009 and 2010. The cuts amounted to 31 percent of the unprotected portion of the general fund.

The roughly \$1.1 billion in general fund spending reductions already passed—not adjusting for inflation and growth in demand—have disproportionately affected some programs and largely spared other programs, as seen in Table 7. Part of the reason for this differential impact is that much of the general fund spending is protected, either permanently by voter initiative (or federal mandate), or temporarily due to the federal stimulus program.

Since the funding for most state agencies comes not only from the general fund, but also from other state funds and from other sources (particularly the federal government), great caution must be exercised in drawing any conclusions from Table 7. A good example is the 68 percent decline in general fund appropriations for the Department of Public Safety. Most of this decrease was offset by an increase in funding from other sources.

**TABLE 7
COMPARISON OF BUDGETS, SELECTED AGENCIES, ARIZONA GENERAL FUND**

Dollars in Millions	Original	Latest Budget for Fiscal Year		Sum Of The
	Budget, Fiscal	2010 Versus the Original		Spending
	Year 2008	Budget for Fiscal Year 2008	Change in	Reductions*
	Dollars	Dollars	Percentage	Change in
			Change	Dollars
TOTAL	\$10,113	\$-1,119	-11%	-\$1,754
EDUCATION	5,801	-363	-6	-817
Dept. of Education	4,027	229	6	-656
School Facilities Board	479	-366	-76	-12
Community Colleges	168	-32	-19	-6
Universities	1,092	-190	-17	-140
HEALTH AND WELFARE	2,690	-501	-19	-806
AHCCCS	1,274	-96	-8	-300
Dept. of Economic Security	797	-251	-31	-389
Dept. of Health Services	578	-134	-23	-98
PROTECTION AND SAFETY	1,123	-124	-11	-53
Corrections	891	-11	-1	-28
Juvenile Corrections	80	-17	-21	-8
Dept. of Public Safety	135	-91	-68	-10
INSPECTION AND REGULATION	49	-16	-32	-9
NATURAL RESOURCES	79	-34	-43	-21
GENERAL GOVERNMENT	370	-81	-22	-49
Courts	127	-7	-6	-6
Dept. of Revenue	74	-37	-50	-13
Legislature	57	-6	-10	-11

* In FYs 2008, 2009 and 2010 relative to the original budget for each year

Source: Arizona Joint Legislative Budget Committee.

Given the existing spending protection provided by the federal stimulus program, it will be impossible to reduce spending enough in the current fiscal year to balance the budget without all but eliminating the correctional system (that is, releasing nearly all prisoners) and other unprotected programs. In FY 2011, less funding will be protected as the federal stimulus protection phases out. By FY 2012, the temporary protection from the federal program will be gone, but considerable funding, mostly for K-12 education and AHCCCS, still will be protected.

Even if the assumption is made that the existing protection and federal mandates would not be an issue in making spending reductions, it will be a significant challenge to reduce general fund spending by \$2 billion (22 percent) more. Existing general fund budgets are shown in Table 1. Education receives 60 percent of the funding and health and welfare receives 24 percent. Even if all general fund support were eliminated for all programs other than education and health and welfare—a completely unrealistic scenario—a deficit of nearly \$700 million would remain.

Thus, it will be impossible to reduce spending by \$2 billion without significant reductions to education and/or health and welfare programs. Even before spending reductions began in 2008, Arizona's spending on these programs was below the national norm. Based on Census Bureau data, per student funding for education in 2007 was second lowest in the country and higher

education funding per student also was well below average. Similarly, spending on public welfare was considerably below the norm, despite the state's higher-than-average needs, as expressed in measures such as the poverty rate.

Thus, an additional reduction in spending of \$2 billion will damage the economic future of the state and its residents and create great hardship now, in the midst of the worst economic conditions since the great depression, on the state's most vulnerable residents. Further spending cuts also will depress an economy struggling to recover. Economic models indicate that a \$2 billion reduction in state spending would cause the loss of another 44,000 jobs—20,000 of them in the private sector.

This scenario also assumes that the past unwillingness to reform the revenue system will persist, even if it were undertaken with the condition of no net increase in revenue. Part of the reason for this assumption is that any revenue reform will consist of increases in some taxes and decreases in others. The constitutional requirement for a two-thirds majority to pass a revenue increase is assumed to preclude such action from occurring.

Inaction regarding Arizona's revenue system means that the high cyclical volatility of revenues will continue. Assuming that the persistent deficit is resolved in the near term through spending reductions, the budget deficits in the next economic downturn will not be nearly as severe as those in the current recession. Still, a typical economic recession will result in a significant cyclical deficit, one that will exceed the funds in the budget stabilization fund assuming its 7 percent cap remains. Thus, each future economic downturn likely will require difficult decisions regarding fund transfers, temporary spending reductions, and other maneuvers to produce a balanced budget.

If the revenue system is not changed, another persistent deficit will gradually appear since the current mix of revenue sources does not provide long-term revenue growth equal to economic growth, mostly due to the high dependence on a sales tax with a very narrow base. This new persistent deficit will become much larger if actions common in the past continue in the future: reducing taxes without commensurate spending reductions, and adding spending obligations to the general fund without a revenue source. Thus, even if the existing persistent deficit is resolved, doing business as usual in the future will eventually result in a repeat of the current conditions: a huge persistent deficit complicated by a cyclical deficit.

In conclusion, balancing the budget completely or primarily through spending reductions will cause immediate hardship on those individuals receiving state welfare services and will cause the loss of tens of thousands of additional jobs. In the longer term, the negative effects of this scenario likely will first affect the key base industries. There likely will be a period of time in which the state continues to grow in employment and population, but during which the state declines to even further below average in measures of productivity and prosperity, including job quality. Eventually, employment and population growth in Arizona will slow substantially, as it has in all mature states and nations. A policy of inaction now will advance the date of the eventual slowdown, perhaps by decades.

SCENARIO 2: POSITIVE ACTION

This section presents an alternative future for Arizona based on a plan that positively deals with the state's economic and fiscal problems. Public policy recommendations are made for balancing the budget, creating jobs in the short term, and enhancing the state's economic competitiveness.

Recommendations for Immediate Action

Balancing the Budget

Conceptually, several options exist to address a budget deficit, but some are not practical solutions to the remaining FY 2010 deficit.

Continued use of one-time options adopted over last two years. A number of one-time actions have been taken to increase revenue in the general fund. According to the OSPB, a total of \$6.9 billion in one-time options have been used over the last three fiscal years. Nearly a third of the total funds provided by one-time actions have come from the American Recovery and Reinvestment Act. This federal stimulus began in FY 2009 and peaked in the current fiscal year at more than \$1.5 billion according to the OSPB; the JLBC indicates that \$1.25 billion was applied to the general fund. The amount available in FY 2011 will be \$800-to-900 million less. No ARRA funds will be available in FY 2012.

Rollovers and transfers from other state government funds into the general fund have been the largest source of the one-time revenues. While these techniques continue to be used, limited revenue is left to be raised through these actions. For example, less than \$100 million was utilized during the fifth special session of the Legislature in December 2009.

Thus, little additional revenue is available to be raised from these types of one-time actions.

Raise one-time revenue from new sources. The potential exists to raise a substantial amount of funds through other one-time actions. One of these, the sale-leaseback of state government facilities executed as lease revenue bonds with a general fund appropriation obligation, is part of the FY 2010 budget. It has generated \$735 million in FY 2010. However, the cost is projected to be about \$43 million next year, with payments continuing for 20 years.

Other monetization options include lottery revenue bonds secured by a pledge of net lottery distribution to the general fund, with an overall general fund appropriation back-stop. This could generate \$540 million, with future costs of \$46.5 million per year for 20 years. Asset-backed bonds tied to the tobacco settlement, with a general fund appropriation back-stop, are viewed as difficult to execute in the current market, but might be able to raise \$950 million, with subsequent payments of \$90 million per year. Vehicle license tax bonds—the redirection of \$22 million of vehicle license tax revenue to pay debt service—possibly could raise \$275 million. If the monetization of both the lottery and the tobacco settlement monies were implemented during the current year, enough revenue would be raised to eliminate the current year's budget deficit.

Such short-term relief, however, comes at a heavy long-term cost: the loss of revenue in each of the next 20 years. In essence, each of these methods is a form of debt. Heavy use of such tools

could reduce the state's credit and issuer ratings, which would result in additional costs to the state. These one-time options do nothing to solve the persistent budget deficit; in fact, they add to the size of the persistent deficit by more than \$100 million per year.

These monetization options also violate the basic principle that long-term debt should only be used for programs that create long-term benefits for future taxpayers. The use of long-term debt makes sense when future generations of Arizonans will benefit from the expenditures. For example, long-term debt financing is generally used for infrastructure projects, such as building new roads and new schools, which will be used long into the future. In contrast, the use of long-term debt to pay for current obligations is widely denounced as improper, causing future residents of the state to pay for services they do not receive.

Reduce spending. The budget deficit in the current fiscal year is estimated at \$1.5 billion. More than half of the fiscal year has already elapsed. Thus, if spending reductions alone were used to balance the budget, the effective reduction would have to exceed \$3 billion on an annualized basis, one-third of the revised budget. This would be on top of the spending cuts already implemented, which have totaled at least 11 percent.

Spending reductions of this magnitude will have significant short-term negative effects on an economy that already is struggling to emerge from recession. Beyond these short-term effects, spending reductions could have a serious adverse effect on the state in the long term by damaging economic development efforts and by reducing the quality of life of Arizona residents. For example, the Arizona Department of Transportation has announced it will have difficulty maintaining the roads that already exist, much less taking positive actions to reduce the traffic congestion already present. Traffic congestion lowers the quality of life of commuters and is a black mark for economic development.

Another example is that Arizona's educational system already is seen as a problem by employers, with a disproportionately high share of children educated in Arizona not graduating from high school. Some of those who have graduated are viewed by employers as not possessing the necessary basic skills to become a good employee. Reductions to education funding can only make such problems worse.

In any case, the reality is that most forms of spending reductions cannot currently be implemented. More than one-third of the appropriations are protected by the voters. Temporarily, even more is protected by the federal stimulus program. The acceptance of the federal monies came with certain conditions. For example, through FY 2011, state funding for education cannot be lowered to below the FY 2006 amount, and through December 2010, eligibility for AHCCCS cannot be reduced. Only \$2.4 billion is currently unprotected, with most of that in the correctional system or in general government.

Thus, balancing the budget in the current fiscal year through spending reductions alone is virtually an impossibility. The special legislative session held in December approved across-the-board reductions of 7.5 percent, but because so much of the budget was protected, this amounted to only \$75 million. Therefore, to achieve any further significant spending reductions in the current fiscal year would require massive reductions to the unprotected programs. While the

unprotected amount is expected to rise to \$3.4 billion in FY 2011, postponing some of the reductions until then still would have a huge effect on the unprotected programs.

Raise revenue by increases in taxes and user fees. It is too late in the current fiscal year to raise much revenue, even if the Legislature were to take immediate action via a two-thirds majority. However, enhancing revenue has great potential for eliminating the deficit in FY 2011.

Raising revenue when faced with a deficit is a common approach, used in Arizona in the early and late 1980s. While not yet used in the current recession in Arizona, many states have increased revenues. In late 2007 and in 2008, 10 states increased taxes or implemented other permanent revenue-raising measures, according to the Center on Budget and Policy Priorities. In 2009, the number increased to more than 30 states. Additional tax increases have been proposed in a number of states.

A dozen states have enacted major revenue packages. The increases have affected a number of taxes. A dozen states have increased sales taxes through rate increases or expansions of the base, with three of the rate increases by at least one percentage point. Eleven states have increased personal income taxes through rate increases, new upper-income tax brackets, or reduced tax credits and exemptions. Increases in cigarette excise or alcoholic beverage tax rates have been passed in 15 states. Twelve states have increased motor vehicle license or gasoline taxes. Business taxes have been increased in 11 states, while other tax and fee increases have been implemented in 15 states. Many states have increased revenues from more than one source for the purpose of diversification.

Unlike raising revenue from one-time sources, permanent increases in user fees and taxes will reduce the size of the persistent deficit. Unlike spending reductions, increasing revenues will allow integral state programs to continue and will preclude additional harm to at-risk populations.

Increases in public revenue will have short-term negative effects on the economy, but the consequences will be less severe than those resulting from a reduction in spending, assuming that any tax increases (and increases in user fees) do not disproportionately affect those with low incomes. An increase in taxes will cause some people to reduce their spending by an equivalent amount, producing the same type of damage to private-sector companies as when government spending is reduced. However, those individuals who are better off financially are unlikely to reduce their consumption; instead, additional tax payments will come from a reduction in savings. Moreover, most of the additional taxes received by state government will be spent either in direct purchases from Arizona companies or in salaries paid to government workers, who spend most of their wages in Arizona.

Also mitigating the negative effects of tax increases (and increases in user fees) is that some of the increased tax burden will be paid by tourists and seasonal residents. In addition, some of the increase in taxes can be exported to the federal government by deducting the state taxes paid from the federal income tax return. Depending on the nature of the tax increases, some of the impact likely will fall on businesses instead of individuals. Increasing state government

efficiency, as by hiring more tax auditors and collectors, means that not all of the enhanced revenue will need to come from tax increases and hikes in user fees.

Thus, if all of the \$2 billion needed to balance the FY 2011 budget were raised from revenues, the net impact on state residents would be considerably less than \$2 billion. This amount would be divided into 6.6 million parts (the estimated number of residents in the state). Even at the full \$2 billion, the per person impact would average only \$303. Assuming that the tax-increase package is progressively designed and includes low-income tax credits, the impact on those with low incomes would be slight.

The REMI model indicates that had state government revenues been increased by \$1.1 billion over the last three years instead of implementing spending reductions, 5,000 to 6,000 fewer Arizonans would have lost their jobs. If revenues are increased \$2 billion instead of spending reductions of the same magnitude, 10,000 fewer Arizonans will lose their jobs.

If general fund revenues in the current fiscal year had been \$2 billion higher, total ongoing revenue would have been only \$39 per \$1,000 of personal income. The historical norm is nearly \$50 per \$1,000 of personal income. Using the Tax Foundation's calculation of tax burden for 2008 (the latest available), and assuming no tax increases in other states (in reality, a number of other states have increased taxes over the last two years) and that all of the additional revenue would be raised from taxes, a per capita increase of \$303 in the tax burden in Arizona would have resulted in a state and local government tax burden of 9.3 percent of per capita income, which would have ranked 32nd among the 51 'states' (including the District of Columbia). Arizona's tax burden exceeded 9.3 percent in all but four years from 1977 (the first year of data) through 1995. In all but two years from 1977 through 1994, the state's rank was higher than 32nd.

Recommendations. The following recommendations are for actions to be taken during the 2010 regular legislative session to be effective by the start of FY 2011. Many of the fiscal recommendations made in this report are similar to those made by the Citizens Finance Review Commission (CFRC) that met during 2003.

1. Let the FY 2010 deficit roll into FY 2011. This is allowed by the Arizona Constitution: "Whenever the expenses of any fiscal year shall exceed the income, the legislature may provide for levying a tax for the ensuing fiscal year sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of the ensuing fiscal year." (Article 9, Section 4).

This recommendation, however, is dependent on the Legislature taking the action required by the Constitution: to levy a tax sufficient to pay the amount rolled over as well as to pay the expenses incurred in fiscal year 2011.

The amount of revenue needed to balance the budget in FY 2011 is estimated at \$2 billion. Most of this is the rollover of the \$1.5 billion FY 2010 deficit. The balance consists of the loss of much of the federal stimulus funding, largely offset by cyclical gains in revenue, and increases in demand for state programs such as AHCCCS.

2. *Raise revenue for FY 2011.* In order to maximize the revenue received in FY 2011 from increases in taxes and user fees, quick action needs to be taken by the Legislature in the 2010 regular session so that the increases take effect by July 1, 2010. Ideally, a two-thirds majority of the Legislature would approve the increases in time for them to take effect on July 1. If instead the increases are referred to the electorate, the full \$2 billion in revenue would not be realized during fiscal year 2011.

Because of this urgency, the recommended actions for the upcoming regular session include a temporary tax increase. While the temporary increase is in place, more extensive and permanent changes to the revenue system can be considered and begin to be implemented.

Since most of Arizona's local governments also are experiencing budget deficits, state revenues should not be raised at the expense of local governments. Instead, the Legislature should take actions that raise the revenue of local governments as well as state government. Moreover, the Legislature should remove obstacles that have been placed on local governments that limit their ability to respond to their own fiscal deficits. For example, the recent limits placed on impact fees should be removed.

A diverse set of sources of revenue, summarized in Table 8, should be tapped so that no single revenue source is exploited too heavily.

A. Restore and expand funding to the Arizona Department of Revenue. Budget cuts since FY 2008 have disproportionately affected the DOR. In order to implement these reductions, the number of tax auditors and collectors has been significantly reduced. Even before these recent declines, the number of auditors and collectors had fallen since the mid-1990s—despite a large increase in the number of Arizona tax filers during this period. A substantial increase in the number of auditors and collectors could occur before the cost of adding these positions would outweigh the additional revenue collected. The CFRC recommended decreasing revenue loss by increasing spending on revenue enforcement until cost-benefit equilibrium is reached, and to implement a system that makes tax avoidance more difficult. Estimates of the amount of revenue that could be realized from this recommendation vary; \$55 million was assumed.

B. Increase federal funding. While the economic downturn has resulted in sharp cyclical revenue declines, it also offers unprecedented opportunities to tap federal funds. The state should move aggressively in coordination with its congressional delegation to secure the state's share of available funding from federal programs put into place to provide assistance to the states. It is not known how much revenue might be gained from this recommendation; it is not included in the \$2 billion total.

C. Properly account for photo radar receipts. Revenue already being collected from photo radar has not been credited to the general fund. Receipts in the current fiscal year are estimated at \$35 million.

D. Institute a home arrest program for nonviolent offenders. Really a cost savings, this could reduce Department of Corrections costs by \$22 million.

**TABLE 8
RECOMMENDED INCREASES IN REVENUE,
FISCAL YEAR 2011, ARIZONA GENERAL FUND**

	Millions of Dollars
Restore and expand funding to the Arizona Department of Revenue	\$55
Increase federal funding	?
Properly account for photo radar receipts	35
Institute a home arrest program for nonviolent offenders	22
Create a utility excise tax	233
Increase the motor vehicle fuel tax	126
Sales tax:	
Temporarily increase the general sales tax rate from 5% to 6%	747
Reinstate the general sales tax on food to be consumed at home (at 6%)	632
Expand the existing low-income credit for increased excise taxes	-345
Eliminate certain tax credits and tax exemptions	22
Property tax:	
Reinstate the statewide property tax at a rate of about 0.37%	250
Phase out the homeowner's property tax rebate	212
Total	1,989

E. Create a utility excise tax. This tax would be applied on power plants for all nonrenewable energy production. Much of the cost would be exported to consumers in other states. A rate of one-tenth of one percent per kilowatt hour would raise around \$233 million.

F. Increase the motor vehicle fuel tax. Arizona's tax rate is below the national average. An increase of five cents would raise about \$126 million. Instead of a fixed rate per gallon, this tax should be shifted to a percentage of the price.

G. Make changes to the sales tax. Raising additional revenue from the sales tax is not an ideal action from the perspective of fiscal guiding principles, in part because of the state's already heavy reliance on this tax. However, the availability of a low-income tax credit places this recommendation more in line with guiding principles. In the longer term, the recommended treatment of the sales tax as part of comprehensive changes to the revenue system is very different, as discussed later in this document.

The primary reason for recommending a temporary increase in the sales tax rate and for expanding the base to include food to be consumed at home is that these are the quickest and most efficient ways of providing substantial additional revenue. Virtually all stores subject to the new sales tax code already remit sales taxes to the state. Thus, the cost to the state and to the stores of implementing the recommendations is minimal.

(1) Temporarily increase the general sales tax rate by 1 percentage point. The general fund portion of the overall sales tax rate (technically, the transaction privilege tax) would increase from 5 percent to 6 percent. The 6 percent sales tax rate should remain in effect through June 30, 2013. As in existing law, the enhanced revenue received from the higher tax rate should be shared with local governments. This increase in tax rate should yield an additional \$750 million for state government and \$200 million for local governments in fiscal year 2011. As the economy improves and consumer spending increases, the amount of revenue collected will rise.

(2) *Resume taxing food to be consumed at home.* The state taxed food to be consumed at home until 1981. Many municipalities still tax these food items today. The primary rationale for bringing back this tax is to broaden the sales tax base in order to reduce cyclicity and to enhance the ability of the sales tax to grow at the rate of the economy. Revenue received from a sales tax on food to be consumed at home is more stable than the substantial cyclicity present through most of the rest of the sales tax base. The rate would temporarily be set at 6 percent to match the temporary rate of the rest of the sales tax. At a 6 percent rate, applying the sales tax to food to be consumed at home would result in revenue of more than \$600 million.

(3) *Expand the existing low-income credit for increased excise taxes.* Since the sales tax is regressive—low-income families spend higher proportions of their income on items subject to the sales tax than do higher-income individuals—and because low-income households cannot absorb a tax increase as easily as those with higher incomes, a low-income credit should be applied to offset the increase in the tax. The CFRC generally recommended that certain low-income tax credits be retained. Individuals using food stamps can be exempted from the sales tax on food at the point of purchase.

The existing low-income tax credit for increased excise taxes was intended to mitigate the increase in sales taxes paid when voters approved a 0.6 percentage-point increase in the general sales tax rate in 2000. (The proceeds of that tax directly benefit education and are not part of the general fund.) The current credit is available to individuals earning no more than \$12,500 and to those filing as head of household or married filing jointly earning no more than \$25,000. The credit is \$25 per person, up to a maximum \$100 for a household. This is a refundable credit, not based on income tax liability.

The existing credit could simply be revised to increase the \$25 per person credit limit to reflect the proposed increase in the tax rate and the expansion of the tax base to include food to be consumed at home. However, an alternative way of structuring the tax credit is recommended.

Rather than the arbitrary maximum income figures of \$12,500 and \$25,000, the maximum allowable income should be tied to the federal poverty level, which varies with household size and is adjusted annually to reflect inflation. In 2009, for example, the poverty level was \$10,830 for a single person and \$22,050 for a family of four. Any tax filer earning less than 150 percent of the poverty level would receive the full tax credit, with the size of the credit gradually decreasing with income, up to a maximum of 200 percent of the federal poverty level. The current household limit, which effectively confines the existing credit to four people per household, could be removed.

Approximately one fourth of the sales tax is paid by low-income individuals. The 2008 American Community Survey indicates that nearly 15 percent of Arizonans were below the poverty level, nearly 10 percent more earned between 100 percent and 150 percent of the poverty level, and that another close to 10 percent had incomes between 150 percent and 200 percent of the poverty level. While nearly 30 percent of Arizonans would qualify for this tax credit, these low-income households do not spend as much per person on taxable items as the average Arizonan. Thus, the expectation is that about one-fourth of the gross additional revenue from the sales tax rate increase and broadening will be refunded, or a sum of \$345 million in FY 2011.

(4) *Eliminate the sales tax collection tax credit.* In an era of computers, the cost to retailers of remitting the sales taxes collected is minimal. This would increase revenue by about \$22 million.

H. Make changes to the property tax. A statewide property tax was in effect until 1997. As with the sales tax, the cost of implementing the recommended changes is minimal since properties subject to a statewide property tax already are taxed by local governments. The property tax provides a relatively stable source of revenue that better matches the stable spending needs of the general fund than the other major revenue sources.

Another reason for selecting the property tax as a source of immediate revenue is that the tax bills mailed in September 2010 will reflect a substantial reduction in assessed value. This reduction in value reflects the decline in property values during the 2008 calendar year. Another significant decline in assessed value will occur in the property tax bills mailed in September 2011.

The decreases in assessed values will be offset to some extent by the likely increase in tax rates set by local governments. However, the percentage increase in the primary property tax levy is limited. Depending on how substantially local governments increase property tax rates, the tax bills mailed in September 2010 (and again in September 2011) could be considerably lower than in the prior year before considering a statewide property tax. Thus, even with a statewide tax rate being applied for the first time in over a decade, overall property tax bills in September 2010 and again in the following year may not be much different than in 2009.

(1) *Restore the statewide property tax.* A statewide tax rate would be applied to the limited property value, not the full cash value. To raise \$250 million in FY 2011, the rate would need to be around 0.37 percent. This is a modest rate compared to that levied by school districts, community colleges, and counties. The cost would be \$37 for a home with a limited property value of \$100,000, which would be close to the median of all residences.

(2) *Phase out the homeowner's rebate.* Residential property owners receive numerous breaks on their property taxes relative to commercial and industrial property owners. First, the assessment ratio is 10 percent for residential properties, but will be 20 percent in FY 2011 for commercial and industrial properties (even after being recently reduced). Second, the total amount of property taxes collected on residential properties for primary purposes cannot exceed 1 percent of the parcel's limited property value. Third, residential owners receive a "homeowner's property tax rebate." The rationale for this rebate originally was to assist low-income homeowners, but the rebate was applied to all residential properties. Effective in tax year 2010, the rebate is 40 percent of the primary school district tax levy, up to a maximum of \$600. Effectively, this is a subsidy of residential property owners.

The homeowner's rebate is estimated to remove about \$425 million from the general fund. It is proposed that this be phased out over two years, such that it saves the general fund a little more than \$200 million in FY 2011. Where possible, the CFRC recommended phasing in major changes to the tax structure, and specifically recommended phasing out the homeowner's rebate.

The statewide property tax would be about the same as the state equalization rate reinstated this fall. The homeowner's rebate or "additional state aid to education" will then be paid to the schools by taxpayers directly through property tax collections. This would start to narrow the wide gap in the tax burden between residential and commercial/industrial properties.

3. *A fiscal system study group should be created during early 2010.* This group should make recommendations regarding permanent changes to the revenue system and to the alignment of the revenue system to expenditures by the end of FY 2011. It should be part of a broader group that makes comprehensive and coordinated recommendations regarding fiscal reform and improvements to economic development.

Job Creation

Approximately 275,000 jobs have been lost in Arizona over the last two years. While the job losses should soon cease, substantial gains in employment are unlikely to occur during the next two years. After that, the rate of job creation should accelerate, with the prerecession level of jobs regained in 2014.

While waiting for jobs to naturally return, limited cost-effective actions can be taken to create jobs in the near term. Though numerous programs might be implemented to enhance economic competitiveness and in the process stimulate job creation, most of these programs take years to realize substantial success and are discussed in the economic competitiveness subsection.

A number of other public programs to boost employment could be implemented in the near term. For example, more highly educated individuals who are unemployed could be hired to provide mentoring to public school students. However, each of these programs would require short-term funding, which would add to the state's budget deficit.

The best short-term economic stimulus is to increase public-sector spending. Since the federal government does not need to balance its budget annually, it is in the best position to do so, and has already acted strongly through its stimulus program (ARRA). Options to stimulate near-term job creation by state and local government are much more limited. Capital spending utilizing long-term financing is the best option since the costs incurred in the short term are modest.

Some states already have implemented job creation programs. Oregon's Jobs and Transportation Act provides \$1.1 billion for transportation projects. In Illinois, the Jobs Now! Program includes \$13 billion in state-issued bonds to go to transportation, education, community development, environmental, and economic development purposes. Ohio's \$1.57 billion Job Stimulus Plan is mostly funded by bonds. It is a mixture of short- and longer-term programs that provide grants and loans to companies in selected export industries, as well as \$400 million in infrastructure grants to local governments.

Recommendations. The following recommendations are for actions to be taken during the 2010 regular legislative session.

1. *Take full advantage of the federal stimulus funding received.* A total of \$4.8 billion is anticipated from FY 2009 through FY 2011. A significant portion is to be used for purposes

other than backfilling government revenue declines. That money should be put to work as quickly as possible.

2. *Release funding for the SPEED program immediately.* If funding were released, benefits could be realized quickly.

The Stimulus Plan for Economic and Educational Development (SPEED) was designed to fund the renovation and restoration of university buildings. The rationale was that the proposed projects had been delayed for years, many buildings were in desperate need of repair, lending costs were near record lows, construction costs were relatively low, and the economy—particularly the construction industry—was in deep recession. In short, needed work could be done at a favorable cost, stimulating a slumping economy.

SPEED was approved by the Arizona Legislature for \$1 billion. Estimates of the potential economic impact at the approved \$1 billion include an increase in employment of 22,200. Though construction and related industries are the most affected by infrastructure spending, the benefits ripple throughout the economy such that the direct effects are less than half of the total.

However, delays in the ultimate enactment of the legislation have resulted in only a fraction of the \$1 billion being released. This delay has occurred despite only modest debt servicing costs that would be incurred in the near term. Based on the original schedule, costs would have been \$1 million in FY 2009, \$13.5 million in FY 2010, and \$41 million in FY 2011.

If the SPEED funds continue to be delayed, the stimulus to the economy will come at a less opportune time. If SPEED funding ends up being further reduced, then future repairs will be made at a time when costs are higher. Further, allocating less funding will result in long-term negative effects that will be felt by the university system and by the state's economy. A lower-quality physical infrastructure at the universities might hamper their ability to attract top students, land research and development grants, and work synergistically with the private sector. In turn, this could result in less economic development in Arizona, lower productivity, and lower wages.

3. *Undertake long-term financing of additional infrastructure building.* For example, freeway construction and construction of university research facilities that already are recognized as needed could be accelerated. Such programs would require additional long-term financing, but if the need already is present and if the benefits will extend to future generations, then the long-term debt-servicing costs are justified.

Economic Competitiveness

Arizona is competing not only with other American states, but with the rest of the world, for the export activities that drive all local economies. This competition has become intense for the high-paying activities with prospects for future growth. Arizona's competitiveness is deemed to be mediocre.

Not all of the factors important to export-based businesses are under the control of local public policy, placing particular relevance on those factors that can be influenced by public policy. Still,

a number of public policy initiatives could be pursued to improve Arizona's economic competitiveness.

If Arizona wishes to increase its competitiveness for the key base industries, then the top priority is education and workforce quality. The second, nearly equal, priority is to improve and expand the physical infrastructure. Tax policy and incentives are of much lesser significance, but targeted business tax reductions and the addition of certain incentives should be pursued. Reductions in business taxes not only would restore fairness between individuals and businesses, but would enhance the state's economic competitiveness.

If the goal were only to continue to grow, then business taxes and incentives join education/workforce quality and physical infrastructure as top priorities. However, if the goal is to improve the state's economic competitiveness, any reductions in business taxes must not result in spending reductions for public services that are important to businesses. With the state's mediocre rating on competitiveness and the already-low public spending, reductions in business taxes will need to be offset by increases in individual taxes.

The strategy to improve the state's physical infrastructure and to lower business taxes is straightforward. In contrast, understanding and improving the educational system and the quality of the state's workforce are more complex topics.

The starting point for this discussion is that the quality of the local workforce is consistently rated at or near the top of the factors determining the economic competitiveness of any region. This is true for all employers, but is particularly the case for employers needing workers who are highly trained in specialized skills. The key base industries require these specialized skills. Currently, Arizona's workforce quality is perceived to be subpar by such employers.

Various aspects of education also appear high on the lists of economic development factors, particularly for modern export businesses. As the world's economy has evolved, becoming more driven by ideas, information, and technology, the importance of education has increased. In particular, higher education (community colleges and universities) has taken on increased significance. Thus, the entire educational system—elementary through graduate school—is the key component of workforce quality, though specialized job training programs also are important.

However, Arizona invests little in its educational system and its K-12 students perform poorly in a variety of measures, including achievement as measured by test scores, attainment as measured by the number of years of schooling completed, and preparation for higher education. It is difficult to conceive of a way to make significant improvements to education that will benefit economic competitiveness without spending more money than what is currently spent. Similarly, the state will need to invest more in its job training programs.

Higher education—in particular research universities—affect economic development in ways other than educating the future workforce. A research university imports money into its local area through its receipt of research funding from federal and other external sources. In this way, a public university is part of the region's economic base, as well as a support for the economic

base. In turn, university research results in new private-sector economic activity. The presence of a research university and its world-class talent also helps to attract leading-edge, high-technology businesses to an area. Access/proximity to universities is separately listed as an important site selection factor.

In addition to the job creation programs recently created in some states, other states have recently implemented or proposed other programs to enhance economic competitiveness. In Colorado, for example, a job training program is under consideration that would be a public-private partnership. Colorado also is considering joining the 20 states that offer a “career-ready” program that certifies the skills of workers, thereby reducing the hiring costs of companies. Missouri has expanded its Quality Jobs program in which certain companies, including technology businesses, retain the withholding tax of new employees. Missouri also is considering a science and innovation reinvestment act. Several states have passed loan programs for small businesses.

Recommendations: Since actions to improve the state’s competitiveness will not result in an immediate improvement in the economy, the focus of near-term action should be to create study groups that will recommend specific actions to improve the state’s competitiveness.

1. An economic development study group should be created during early 2010. This group should make recommendations regarding changes to the state’s economic development policies by the end of FY 2011.

2. An education study group also should be created during early 2010. This group should make recommendations regarding the specific changes to the state’s educational system that are needed to enhance student achievement and attainment and thereby make the state more economically competitive. An end of 2011 deadline is foreseen for this group.

Along with the fiscal study group, the economic development and education study groups should be part of a broader group that makes comprehensive and coordinated recommendations regarding fiscal reform and improvements to economic development.

Recommendations for Longer-Term Actions

Since recommendations for longer-term changes to public policy will be made by the study groups, many of the recommendations discussed below are not specific. However, in order to provide a complete fiscal plan, relatively precise suggestions are provided for balancing the budget.

Balancing the Budget

The recommendations for immediate action discussed above include a \$2 billion increase in revenues in FY 2011, with an additional \$200+ million to phase in during FY 2012. However, this still is not enough to eliminate the persistent deficit. Completely offsetting the persistent deficit is postponed for two reasons: (1) to allow time for the study groups to make recommendations and for the Legislature to take action; and (2) to wait until the economy is stronger. The following discussion assumes that the permanent changes in the revenue system will be put in place in FY 2014, though this likely could be accomplished a year earlier.

The state's large persistent deficit coupled with selected decreases in business taxes in order to improve the state's economic competitiveness (discussed in more detail in a succeeding subsection) means that a substantial increase in the personal tax burden will be necessary. As discussed earlier, such an increase will do little more than offset the tax reductions put in place since the early 1990s, returning personal tax burdens to near the state's historical norm. Even if all of the impact of the revenue increases needed to eliminate the persistent deficit fell on state residents, the per person impact would average only \$364 in today's dollars.

An increase of this magnitude will not put the state's tax burden out of line with other states. If the 2008 tax burden had been \$364 per person higher, the state would have ranked 26th in the nation. Further, total revenue per \$1,000 of personal income will rise only to \$47, still less than the nearly \$50 historical average.

Recommendations. The following set of revenue proposals, summarized in Table 9, raises revenue from several distinct sources, secures revenue flows by providing funding for auditors at the Department of Revenue, seeks optimum use of federal funds to make sure the general fund can be used for the purposes originally intended, and removes school construction from the general fund. It also provides a pool of designated funds to mitigate regressivity and another pool to be used for incentives. While the focus of the plan is revenue, the fiscal system as a whole must also be considered; a few of the recommendations apply to the fiscal system.

The recommended increases in revenue will not completely offset the persistent deficit until FY 2014, when the recommended revenue increases become greater than the persistent deficit. This larger revenue hike is necessary in order for the state to repay its debts and to begin to rebuild the budget stabilization fund. Later, either revenues could be slightly decreased or spending could be increased to closer to its historical level per \$1,000 of personal income.

Though many options exist, the proposed revenue system aligns well with the guiding principles. The overall revenue base associated with this initiative is broader and less cyclical than the current general fund base, and will grow more closely with economic growth. The tax initiatives are largely directed at individual tax burdens that are very low in Arizona compared with other states. Dependence on the sales tax will shrink compared to FYs 2009 and 2010, even with the large increases proposed for FYs 2011 through 2013. Starting in FY 2014, the sales tax will make up a share of revenues comparable to historical conditions. The other highly cyclical tax source, the income tax, also will provide a lesser share of total general fund revenue than during the last 30 years, even after individual income tax rates rise in FY 2014.

1. Increase tax revenue.

A. Sales tax. The state is highly dependent on the general sales tax for revenue despite its narrow base. As currently structured, the tax compares unfavorably to the fiscal guiding principles. According to the District of Columbia tax burden study, the sales tax burden in Arizona is very high relative to other states. The sales tax is regressive with a much higher burden at the lowest income (\$25,000) and the lowest burden at the highest income.

The temporary increase in the sales tax rate that is recommended to be in effect from FY 2011 through FY 2013 is contrary to the guiding principles but is necessary given the requirement to

close the large deficit. The broadening of the sales tax base to include food to be consumed at home coupled with a low-income tax credit that is recommended for implementation in FY 2011 and to continue permanently, is a first step toward improvements in the sales tax.

Additional permanent changes to the sales tax should include further broadening of the sales tax base to include consumer services and labor in construction. Consumer services include private professional education services, waste services, personal services, photography, building security and maintenance services, and private auto sales. This broadening will result in less cyclical variation in tax collections and growth in revenues that better keep pace with economic growth.

**TABLE 9
RECOMMENDED INCREASES IN REVENUE,
FISCAL YEARS 2011 THROUGH 2015, ARIZONA GENERAL FUND**

	Dollars in Millions*				
	2011	2012	2013	2014	2015
Sales Tax:					
Changes in rate	\$747	\$823	\$897	\$-969	\$-1,036
Broaden base: food to be consumed at home	632	654	684	485	505
Other base broadening	0	0	0	1,323	1,379
Low-income tax credit	-345	-369	-395	-210	-212
Reduce tax credits and tax exemptions**	22	23	24	24	25
Property Tax:					
Statewide property tax	250	264	281	299	317
End the homeowner's property tax rebate	212	439	459	488	518
Individual Income Tax:					
Change in rate	0	0	0	359	388
Reduce tax credits	0	0	0	136	145
Corporate Income Tax:					
Change in rate	0	0	0	-192	-208
Pool for incentives	0	0	0	-62	-66
Other Taxes:					
Vehicle license	0	0	0	248	259
Alcoholic beverages	0	0	0	20	21
Motor vehicle fuel	126	131	135	140	145
Utility excise tax	233	241	250	259	268
Fees:					
Health care provider	0	0	0	288	300
Other fees	0	0	0	310	329
Other:					
Federal funds	?	?	?	?	?
Photo radar	35	36	38	39	40
Additional tax auditors and tax collectors	55	57	59	61	63
Corrections home arrest	22	23	24	24	25
Total Increase in Revenue	1,989	2,321	2,455	3,072	3,207
"Persistent" Deficit	2,261	2,385	2,541	2,704	2,873

* All figures are adjusted for the effects of inflation and population growth.

** Conservative; no estimate available for savings from tax exemptions

The sales tax rate should be lowered—from the existing 5 percent and the temporary 6 percent—to 4 percent in order to reduce the dependence on the sales tax. Lowering the sales tax rate and continuing the sales tax credit will help to reduce regressivity.

The numerous sales tax exemptions need to be evaluated. Many of these exemptions are believed to serve little useful purpose and to violate the fiscal guiding principles, particularly those of neutrality and horizontal equity. The amount of revenue to be gained from eliminating some of the exemptions is unknown and has not been included in Table 9.

The CFRC made several recommendations regarding the sales tax that are in line with the proposals of this paper: expand the tax base to better mirror the state's economy; broaden the tax base to include consumer services; broaden the tax base by including certain transactions that currently are exempt; lower the tax rate in conjunction with eliminating certain exemptions and broadening the tax base; establish policy guidelines to test the soundness of future proposed tax exemptions; and include a sunset provision to each exemption.

B. Property tax. The reinstatement of the statewide property tax and the phase-out of the homeowner's property tax rebate proposed to begin in FY 2011 are recommended to be part of the permanent changes to the revenue system. However, it is suggested that much of the new revenue/recovery of revenue currently lost be moved out of the general fund along with funding for the School Facilities Board. The inclusion of capital spending in the general fund is inappropriate and the construction and maintenance of schools should have a dedicated revenue stream. The CFRC recommended generally that capital financing tools be used for long-term capital assets with debt service tied to specific revenue streams and specifically that the general fund not be used to finance school construction, with a new process adopted that utilizes local school district, county, or state property taxes.

Various other modifications to the property tax are recommended; some are discussed in the following subsection on economic competitiveness. The constitutional 1 percent cap on residential real estate taxes for primary purposes should be eliminated. In order to protect low-income homeowners from tax increases resulting from this and from the elimination of the homeowner's rebate, the first \$xx,000 of the assessed value of improved property could be exempted from the tax. This exemption is intended to be implemented in a revenue-neutral fashion—the loss of revenue from the exemption would be offset by an increase in the statewide tax rate.

According to the District of Columbia tax burden study, the residential property tax in Arizona is among the lowest in the country. Thus, the tax could be increased considerably, as recommended, without becoming out of line. The study also shows that the property tax as applied in Arizona is regressive, with high-income homeowners paying a lesser share of their income than lower-income homeowners. Exempting the first \$xx,000 would eliminate this regressivity.

C. Income tax. Three changes are proposed to the income tax, to be effective in FY 2014: (1) increase personal income tax rates; (2) decrease the corporate income tax rate to the highest

personal income tax rate; and (3) eliminate some of the tax credits. In addition, revenue from the corporate income tax should be reserved for the use of corporate incentives.

Individual income tax rates are proposed to rise 10 percent, reversing the tax cut that was implemented in 2007 and 2008, raising about \$350 million in FY 2014. The rate in the highest income tax bracket will be 4.994 percent. In addition, the public and private school tax credits are eliminated under the plan, saving approximately \$136 million in FY 2014. The CFRC recommended that corporate and personal income tax credits be used as little as possible. It particularly suggested a review of the effectiveness of the private-school tuition and extracurricular public-school tax credits.

The increase in revenue from the personal income tax will be partially offset by the reduction in the corporate tax rate. If the corporate income tax rate is cut from the current 6.968 percent to the top rate on the individual income tax of 4.994 percent, a 28 percent drop, the result is a decline of revenue of about \$192 million in FY 2014.

A portion of the corporate income tax collections are recommended to be set aside for use in targeted incentives, workforce training programs for export-based businesses, or other relocation enticements. The use of these funds, about \$62 million in FY 2014, should be restricted to base industries that pay high wages. All incentives should include “claw-back” provisions that require a business to pay back an incentive if the business does not deliver on the stated provisions, such as creating a certain number of jobs in Arizona.

According to the District of Columbia tax burden study, the individual income tax in Arizona is among the lowest in the country of those states utilizing this tax source and ranks about 40th among all states. The small recommended increase in the tax would not change Arizona’s ranking.

D. Other Taxes. The increase in the motor fuels tax and the utility excise tax recommended for FY 2011 should be continued. In addition, a 25 percent increase in the motor vehicle license tax is recommended for implementation in FY 2014. The estimated \$248 million raised would be designated to go to the general fund, as did a portion of the vehicle license tax before 1999. A 25 percent increase in the luxury tax on alcoholic beverages also is recommended, raising about \$20 million in FY 2014. The modification in the luxury tax should include changing the tax from a fixed dollar figure per unit to a percentage of the price. The CFRC recommended that unit-based fees and taxes be replaced with percentage-based fees and taxes.

2. Increase user fees.

A. Health care provider fee. According to the National Conference of State Legislatures (NCSL), a provider fee is a state law that authorizes collecting revenue from specified categories of health care providers. In most states it is used as a mechanism to generate new in-state funds and match them with federal funds so that the state gets additional federal Medicaid dollars (the AHCCCS program in Arizona). In a majority of cases, the cost of the tax is promised back to providers through an increase in the Medicaid reimbursement rate. Beyond Medicaid, states have

the policy option to tax most types of providers and services, including health care, and to designate or earmark the revenue for any state purpose.

Under federal law and regulations, a state's ability to use provider-specific taxes to fund their state share of Medicaid expenditures is limited. Those taxes cannot generally exceed 25 percent of the state (or nonfederal) share of Medicaid expenditures, and the state cannot provide a guarantee to the providers that the taxes will be returned to them. Despite these federal limitations, many states are now using or considering the use of provider taxes, sometimes to supplement static or declining provider reimbursement rates. In part this is because of a federal "safe harbor"—if the taxes returned to a provider are less than 6 percent of the provider's revenues, the prohibition on guaranteeing the return of tax funds is not violated. As a result, a state can currently impose a provider tax of 5.5 percent of revenues, return those revenues directly back to those providers in the form of a Medicaid payment, and receive a federal match for those amounts.

An increase in health care provider fees is estimated to have the capacity to raise upwards of \$300 million in Arizona in FY 2014.

B. Other fees. Overall, the collection of state government user fees in Arizona is well below the national per capita norm. Per capita fees are less than the U.S. average in nearly every category tracked by the U.S. Census Bureau, with the differential especially large in health care. Implementing the health care provider fee would make up only about half of the state's shortfall in per capita health care fees. Even assuming more than \$300 million in revenue from new or increased fees in addition to the health care provider fee, per capita fees in Arizona still would be less than the U.S. average.

The CFRC recommended hiring a consultant to examine the fairness and extent of the various fees. The review will reveal those fees that are too low to cover costs and that are low relative to national averages. Per unit assessments should be replaced by percentages of the dollar value of transactions so that collections keep pace with inflation.

3. Other.

A. Federal funds. The CFRC recommended that information on federal funds be centralized in an effort to increase the federal grant dollars received. The amount of additional revenue is unknown.

B. Money management. The additional tax auditors and collectors at the Arizona Department of Revenue that were recommended for immediate implementation should be continued. Other improvements to money management also are possible. The CFRC made several recommendations regarding improving fiscal practices: assign the specific responsibility for long-term planning to a particular agency or committee; in addition to the current practice of cost accounting, utilize accrual accounting on a selective basis to provide long-term planning data; and maximize the time-value of money by increasing interest earnings through the use of frequent deposits, longer-term, higher-interest accounts, and other fiscal measures.

C. Budget stabilization fund. The state's budget stabilization fund should be strengthened. The cap should be raised to 15 percent or higher, the formula used to allocate funds to the BSF should be changed so that more money is transferred into the BSF more quickly following a recession, and the legislation should be tightened so that BSF funds can be used only to offset cyclical decreases in revenues. Ideally, the operation of the BSF would be placed in the Constitution.

The CFRC recommended that the limit on the BSF be raised to 15 percent and that measures be taken to make raids on the fund more difficult.

D. Accountability. It should be statutorily required that any reduction in tax rates be immediately offset by specified reductions in spending or by increases in other revenues. Similarly, an immediate increase in revenue should be required for any new or expanded spending program, or a comparable amount of other spending should be reduced.

Job Creation

The SPEED program was designed to last two years, and the federal stimulus funds will expire before that. However, the effects of these programs will last longer, since many of the construction projects will take upwards of two years to complete. When the effects of these short-term stimulus programs end, job growth in Arizona will be strengthening due to the economic cycle. Unlike many states, numeric job creation in Arizona is not an issue except temporarily during recessions. The major issue in Arizona is job quality, which is related to economic competitiveness, discussed below. Thus, no long-term programs for job creation are recommended. Instead, the focus should shift to long-term improvements to the state's economic competitiveness.

Economic Competitiveness

The ultimate goal of economic development should be to improve the economic well-being of all Arizonans. To accomplish this, the state should adopt the following goals:

- De-emphasize the importance of aggregate economic and population growth. In its place, emphasize gains in various productivity and prosperity measures.
- Increase the workforce participation rate across the state.
- Improve job quality.

The following broad strategies should be pursued in order to achieve these goals:

- Improve the quality of the workforce by augmenting the educational system and job training programs.
- Enhance and expand the physical infrastructure.
- Reduce the tax burden of selected base industries.
- Focus economic development efforts on the key base industries.
- Place particular attention on the geographic areas and demographic groups most in need of help.

1. Education and Job Training. The goal of the elementary and secondary educational system should be to prepare all children to become productive members of society. In a society in which a very high percentage of individuals will hold a job outside the home at some point during their

lives, children should be given an education that prepares them to be competitive in seeking a quality job.

It is probable that some improvements in the educational system can be accomplished without the expenditure of additional funds. However, it is foolish to think that Arizona can spend nearly the least in the nation per student on its K-12 educational system and be successful. Clearly, this has not happened: Arizona has a high dropout rate and low student achievement.

Funding for higher education also has fallen over time to a level well below the national norm. This is particularly unfortunate for the state's future prospects given the increased importance of higher education as the economy evolves to one much more dependent on ideas and technological advances.

If spending for public education (P-20) is to increase, then revenues will have to be raised—over and above the revenue increases recommended earlier in this section to balance the budget. Once a balanced revenue system is created, changes in spending needs would best be achieved by proportional increases or decreases in tax rates and user fees across the system.

Simply providing a quality education for all children and for all adults who wish to pursue higher education will not be enough to ensure that Arizona's workforce is competitive. Technology changes constantly; some jobs diminish in number while new occupations are created. Thus, job training programs are a necessary component of creating and maintaining a quality workforce. Special emphasis needs to be placed on skill development tailored to new and prospective export-based businesses.

Arizona's educational and job training systems need to work more closely with Arizona employers to ensure that students are receiving the education and training they need to find quality jobs. Efforts to match qualified students to job opportunities should be enhanced. This is of particular significance in the high-technology industries that are expected to lead the state's growth.

2. Physical Infrastructure. To be economically competitive, the state's physical infrastructure must meet the needs of employers. Much of the physical infrastructure, such as transportation, is primarily provided by the public sector. While other aspects of the physical infrastructure, such as utilities, may be largely provided by the private sector, the public sector usually has at least a regulatory role to play in those types of infrastructure.

The infrastructure needs and options are documented; what is most needed is additional funding. While provision and maintenance of the physical infrastructure is expensive, the costs can be spread out over a long time span because of the long useful life of most of the infrastructure. In some cases, the costs need not be borne by the public sector, but the public sector must be responsive to the needs through its long-term planning and regulatory functions. Still, improving the state's infrastructure will require considerable additional public funds, over and above those needed to balance the budget and improve the educational system and job training programs. Additional funding for debt repayment should be achieved by proportional increases in tax rates and user fees across the revenue system.

3. *Tax Policy.* The Ernst & Young business tax burden study shows that businesses pay an above-average amount in sales taxes in Arizona. Lowering the tax rate while extending the base in ways that largely will not affect businesses, as discussed above in the “Balancing the Budget” subsection, will effectively lower the business sales tax burden and thus improve economic competitiveness. While the amount paid through the corporate income tax does not appear to be in itself out of line, the reduction in the corporate income tax rate coupled with the increase in the individual income tax rate will eliminate the current disparity between corporations and businesses that file income tax using the individual tax forms. This should be of particular benefit to high-tech businesses and other export businesses.

The creation of a pool of funds to be used for incentives also will enhance economic competitiveness. These incentives must be limited to export industries that pay high wages. In particular, the focus needs to be on technology industries in which Arizona has a comparative advantage.

These recommendations, however, do not go far enough to reducing the overall business tax burden or to restoring equity between businesses and individuals in the amount contributed to the public sector relative to the costs imposed on the public sector. Two additional changes to the property tax are recommended.

First, the personal property tax applied to business equipment should be reduced or eliminated. It is the prime candidate to achieve the Laffer Curve effect of an increase in revenue despite a decrease in taxes. The business property tax is a narrow tax that has been demonstrably high relative to other places. It is a tax that disproportionately affects some businesses, particularly manufacturers who use considerable equipment in their operation. High-tech manufacturers, such as semiconductor plants, are among those with considerable equipment. These companies pay high wages. Lower business property taxes might encourage companies to expand facilities in Arizona. Although most of the labor force needed for an expansion would be imported, the high wages of these new workers could result in a net positive effect even on public-sector finance. Fifteen years after the first tax cuts were implemented, some reduction in the business property tax currently is being phased in.

Reductions in the business personal property tax will need to be offset by further increases in the tax burden on residential properties. However, it is possible that over time the business tax reduction will more or less pay for itself, reducing the long-term increase on residential property taxes.

Second, the assessment ratio for business property taxes should be set equal to those of residences. The assessment ratio should be that rate that achieves a balance between the reduction in business taxes paid and the increase in residential taxes. The precise consequences of this uniform assessment strategy would have to be established. Using a uniform assessment ratio, residential properties would pay about 65 percent of the total tax burden and about \$130 million more than under the existing system. Business property owners would pay \$130 million less and only about 17 percent of the total burden.

The CFRC made several recommendations regarding the property tax that are in line with the proposals of this paper: reduce overall business property tax burdens; reduce the business personal property tax; re-enact the option of a state property tax; move toward uniform assessment ratios; and eliminate the 1 percent cap on the residential property tax.

4. Economic Development. Many of the state's economic development agencies already have as a goal the expansion of high-paying, high-technology industries. This must become the state's overarching goal as well. However, this is not a reasonable goal in most of the rural parts of the state that have the greatest needs. In some rural areas, the primary problem is a shortage of jobs. In areas with adequate job growth, the issue is more one of creating better jobs than those that dominate today. However, workforce quality is a significant issue in many of these areas—job creation may be adequate in number, but newcomers instead of unemployed local residents fill the jobs as they are created.

The state is the only economic development entity that can ensure that economic development is geographically broad based and helps those Arizonans most in need of assistance. To the extent possible, the state should work with employers to locate jobs in areas of need. A job that might be considered a bad job in the Phoenix area could be considered a good job in some rural areas.

The economic development community also must be given the tools they need to compete effectively. As already discussed, a more qualified workforce, a stronger infrastructure, lower business taxes, and greater availability of incentives will go a long way toward eliminating the state's current deficiencies. However, the competitiveness study group presumably will bring forward other recommendations as well on topics such as improved business financing and increasing the amount of research and development funding.

Year-by-Year Summary

The projected year-by-year increase in revenue from implementing the plan is shown in Table 9. Projected total ongoing revenues and ongoing expenditures in the state's general fund are presented in Table 10. Enough federal stimulus funds will remain in FY 2011 to cover the projected deficit. Though surpluses begin to be realized in FY 2012, this is due to the constraints on spending that remain in place. The surplus increases in size in FY 2014 as additional revenue streams are implemented.

All of the apparent surpluses through FY 2015 (and beyond) already are allocated. The surpluses in FYs 2012 and 2013 and part of the surplus in FY 2014 should be used to reverse the fund transfers and other one-time actions that were employed between FYs 2008 and 2010. The remainder of the FY 2014 surplus and part of the FY 2015 budget should be used to reverse the spending reductions imposed in the general fund between FYs 2008 and 2010. The remainder of the FY 2015 surplus, as indicated in the bottom row of Table 10, should be placed in the budget stabilization fund.

The general fund will not continue to generate surpluses as large as shown in the bottom line of Table 10. FY 2015 is projected to be a year of strong economic growth, generating stronger-than-average revenues. As economic growth slows, the annual surplus will become smaller and then become a cyclical deficit.

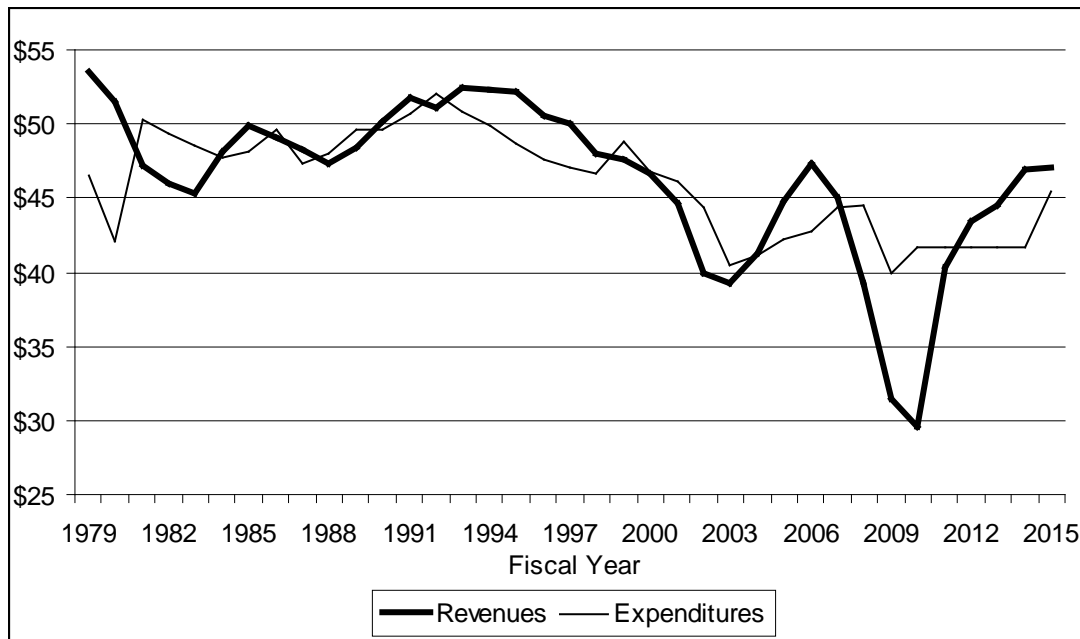
**TABLE 10
PROJECTED ONGOING REVENUES AND EXPENDITURES,
FISCAL YEARS 2011 THROUGH 2015, ARIZONA GENERAL FUND**

Fiscal Year	Revenues	Expenditures*	Balance
2011	\$9,047	\$9,348	\$-302
2012	10,262	9,863	399
2013	11,227	10,508	719
2014	12,589	11,182	1,407
2015	13,398	11,880	1,518
2015**	13,398	12,963	435

* Expenditures are based on the current appropriations for FY 2010, adjusted for inflation and increases in caseloads.

** The alternative for FY 2015 shows expenditures after the spending reductions put into place between FYs 2008 and 2010 are reversed.

**CHART 2
ONGOING REVENUES AND EXPENDITURES PER \$1,000 OF PERSONAL INCOME,
INCLUDING PROJECTIONS THROUGH FISCAL YEAR 2015,
ARIZONA GENERAL FUND**



Note: The FY 2010 figures reflect projected revenues as of January 2010, appropriations adjusted for the reductions passed in the special sessions in fall 2009, and projected personal income.

Source: Arizona Joint Legislative Budget Committee (historical data) and Arizona State University, Office of the University Economist (projections).

Thus, despite a recommended revenue increase of \$2 billion in FY 2010, rising to \$2.4 billion in FY 2014 (before adjustment for inflation or population growth), barely enough revenue will be raised to correct the state's fiscal deficiencies. As shown in Chart 2, revenues and expenditures per \$1,000 of personal income will remain slightly below historical averages even in FY 2015.

If the recommendations to improve economic competitiveness are adopted—increased spending for education, job training, and physical infrastructure—then revenue and spending needs will be greater than shown. Per \$1,000 of personal income, the levels will need to go to at least those that prevailed in the 1970s and 1980s.

Fiscal Year 2010 (through June 30, 2010)

Fiscal:

1. Let the remaining FY 2010 deficit roll into FY 2011.
2. Raise revenue for FY 2011:
 - A. Restore and expand funding to the Arizona Department of Revenue.
 - B. Increase federal funding.
 - C. Properly account for photo radar receipts.
 - D. Institute a home arrest program for nonviolent offenders.
 - E. Create a utility excise tax.
 - F. Increase the motor vehicle fuel tax.
 - G. Make changes to the sales tax.
 - (1) Temporarily increase the general sales tax rate by 1 percentage point.
 - (2) Resume taxing food to be consumed at home.
 - (3) Expand the existing low-income credit for increased excise taxes.
 - (4) Eliminate the sales tax collection tax credit.
 - H. Make changes to the property tax.
 - (1) Restore the statewide property tax.
 - (2) Phase out the homeowner's rebate.
3. Create a fiscal system study group.

Job Creation:

1. Take full advantage of the federal stimulus funding received.
2. Release funding for the SPEED program immediately.
3. Undertake long-term financing of additional infrastructure building.

Economic Competitiveness:

1. Create an economic development study group.
2. Form an education study group.

Fiscal Years 2011 and 2012

The study groups present recommendations for comprehensive solutions to the state budget and economic development issues.

Fiscal Year 2013

Legislation regarding comprehensive solutions to the state budget and economic development issues is passed for implementation in FY 2014.

Fiscal:

1. Increase tax revenue.
 - A. Sales tax.
 - (1) Reduce the tax rate to 4 percent.
 - (2) Broaden the tax base to include various services.
 - B. Property tax.
 - (1) Create a new fund for the School Facilities Board, with revenue coming from the property tax.
 - (2) Eliminate the constitutional 1 percent cap on residential real estate taxes for primary purposes.
 - (3) Exempt the first \$xx,000 of the assessed value of improved property, with the revenue lost offset by an increase in the statewide tax rate.
 - C. Income tax.
 - (1) Increase personal income tax rates.
 - (2) Decrease the corporate income tax rate to the highest personal income tax rate.
 - (3) Eliminate some of the tax credits.
 - (4) Reserve some of the revenue from the corporate income tax for the use of corporate incentives.
 - D. Other taxes.
 - (1) Increase the motor vehicle license tax with the revenue designated to go to the general fund.
 - (2) Increase in the luxury tax on alcoholic beverages.
2. Increase user fees.
 - A. Implement a health care provider fee.
 - B. Increase other fees.
3. Other.
 - A. Seek additional federal funds through a centralized effort.
 - B. Improve money management.
 - C. Strengthen the budget stabilization fund.
 - D. Improve accountability.

Economic Competitiveness:

1. Improve education and job training.
2. Expand and improve the physical infrastructure.
3. Tax policy.
 - A. Reduce or eliminate the personal property tax applied to business equipment.
 - B. Set the assessment ratio for business property taxes to be equal to those of residences.
4. Create a statewide economic development policy with flexibility to account for varying conditions across the state.

Conclusion

Back in the 1970s and early 1980s, Arizona's economic performance was better relative to the national average than it has been since then. Arizona was close to the national average on productivity and prosperity measures such as earnings per employee and per capita personal income. High-technology activities were a larger share of overall economic activity than they are

now. All of the factors causing Arizona's relative decline since then are unclear, but a few can be cited.

Some of the state's early success in attracting high-technology operations had little to do with the location factors that are important today. The electronics and aerospace industries were initially attracted to the state because of its climate, open spaces, and low costs, particularly for large parcels of land. As companies evolved in their requirements, many regions of the country (and elsewhere in the world) improved their economic competitiveness and economic development strategies to meet the evolving needs of modern export companies. In particular, the northeastern United States went from a long economic slump to being a premier location for high-tech companies, starting in the late 1970s. In contrast, Arizona did little to advance itself. Until the Arizona Strategic Planning for Economic Development effort began in 1989, Arizona's economic development looked much as it had decades before.

Economic development efforts in Arizona have evolved substantially since 1989, likely playing a role in ending the sharp decline that occurred during the 1980s and early 1990s in productivity and prosperity relative to the national average. Still, the state has not regained the ground that was lost.

While Arizona's economic development has been modernized, the state's investments in itself—in the factors that not only will enhance its economic competitiveness but improve the quality of life of all of its residents—have continued to deteriorate. A reduction in the investment in education began in the 1980s. Until then, Arizona's operations spending for K-12 education had been near, if not above, the national average, and its higher education spending was not too far below the norm. Not only has education spending continued to decline relative to the nation, investments in physical infrastructure are lagging, updating of an outdated tax system has not occurred, and a variety of other public programs either have not been adopted or have not been adequately funded. In essence, the state has a modern economic development community using tools from a previous time, to the extent that tools are even available.

Adopting the recommendations in scenario 2 will allow the state to begin to catch up after decades of neglect. However, progress will be slow, even if all of the recommendations are adopted and funded. Had Arizona changed its course in the 1980s when it was a much less populous state, it would have been easier and quicker to reach its goals. Now, with an economy of 3.3 million workers and a state of 6.6 million residents, doing everything right will yield only slow improvements. Moreover, economic competition continues to strengthen from other regions of the country and from other countries.

The alternative, though, is clear, as laid out in scenario 1. Without action, the state will continue to deteriorate relative to the nation until it reaches a point that it no longer is a desirable location for businesses or individuals to locate—despite its natural attributes. By the time that happens, the quality of life of its residents will have declined—the state will have reached second-class status.