

Abbreviated Version of A SUMMARY OF THE ARIZONA STATE GOVERNMENT FISCAL SITUATION

**A Report from the Office of the University Economist
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ARIZONA STATE UNIVERSITY

PART I: BACKGROUND

TAXES AND PUBLIC-SECTOR SERVICES

- Taxes are the price paid for public services.
- Many services of state and local governments impact everyone and are valued by individuals and businesses alike.
 - Examples include roads and other transportation, police and fire protection, K-12 education, water provision and sewer services, trash collection, the judicial system and the correctional system.
- **MYTH: Taxes remove money from the economy.** Government revenue is spent in much the same way as private-sector revenue, including the payment of employee wages and the purchase of materials and services from the private sector. The in-state multiplier effect is larger for public-sector spending.

COUNTERCYCLICALITY OF DEMAND FOR PUBLIC SERVICES

- In the private sector, demand for goods and services declines during a recession, causing companies to layoff employees.
- In the public sector, demand for most services does not change during a recession.
- Demand for some public services -- such as public welfare and university enrollment -- countercyclically rises during a recession.
- Thus, public spending cuts during a recession reduce the quality and/or quantity of public services.
- **MYTH: The size of government should shrink during recessions.** Most businesses experience a decline in demand for their products or services during a recession, and thus reduce the size of their workforce. However, the public sector does not experience lowered demand for its services during an economic downturn. Most government programs serve residents, who continue to require public services. Demand for some government programs, such as unemployment benefits, rises during recessions.

PUBLIC SERVICES AND ECONOMIC DEVELOPMENT

- Many public services — such as education (kindergarten through graduate school) and provision and maintenance of physical infrastructure — are of key importance to businesses, particularly high-technology and other “new-economy” companies.
- Tax reductions financed by cutting education, infrastructure spending, and other services valued by businesses will have a negative effect on economic performance.
- **MYTH: Reduced government size is good for the economy.** The public sector provides numerous services, many of which are valued by the private sector. Education and the physical infrastructure are of particular importance to businesses. Taxes are the price paid for these services and need to be evaluated relative to the public programs they fund.

SIZE OF STATE AND LOCAL GOVERNMENT TAXES

- According to the Tax Foundation, all state and local government taxes — including those paid by businesses — account for less than 10 percent of income nationally, with the share in Arizona lower at 8.5 percent.
- Despite the attention given to taxes, tax payments are a small 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 — account for only a little more than 2 percent of operating income of all businesses.
- **MYTH: State and local government taxes are a major expense.** Total taxes collected by all state and local governments in Arizona are less than the taxes the federal government collects from Arizonans. For businesses, state and local government taxes typically are less than 2 percent of operating income — less than officers' compensation.

TAXES, PUBLIC REVENUE AND ECONOMIC GROWTH

- The bulk of the modern literature indicates that state and local government taxes have only a small effect on economic growth.
 - State and local government taxes are not that significant an expense to either households or businesses.
 - Taxes merely represent the price paid for government services consumed, with many state and local government services of high value to individuals and businesses alike.

LAFFER CURVE AND SUPPLY-SIDE ECONOMICS

- A single tax rate produces the greatest government revenue: the revenue-maximizing rate (RMR).
 - The RMR is the rate that allows sufficient investment in public amenities that foster economic growth without imposing tax burdens that stifle growth.
- The relationship between tax rates and revenue collected follows a curve (the Laffer Curve).
 - 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.
- 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.
- Proponents of limited government erroneously argue that tax rates are always above the RMR and reduced taxation is always better.

TAX CUTTING IN ARIZONA: CONCEPTUAL BASIS

- When state government began to reduce the tax burden in 1993, Arizona's overall state and local government tax burden already was less than the national average and lower than it had been in the late 1970s, based on the Tax Foundation's measure of tax burden.
 - Thus, Arizona was not generally in a position to benefit from a series of tax cuts, either in terms of enhanced government revenue or economic performance.
- For a net positive effect on government finance to be realized from reducing taxes, a region must have underutilized resources (high unemployment and high commercial and industrial vacancy rates).
 - Arizona has had neither high unemployment rates nor high commercial/industrial vacancy rates.
 - Thus, even assuming that tax cuts in Arizona had an effect on economic growth, the requirement of excess capacity is not met in order for a net benefit to accrue.
 - Thus, even if public revenue increased, the need for public spending also would have risen.

TAX CUTTING IN ARIZONA: CONCEPTUAL BASIS

- Most of the taxes cut in Arizona since the early 1990s have been taxes applied to individuals that already were lower than the national norm.
 - Using the Laffer Curve, this suggests that the individual tax cuts in Arizona should have decreased, not increased, government revenue.
- The corporate income tax rate was relatively high before tax cuts were implemented.
 - While these tax cuts might have generated a Laffer Curve effect, the magnitude of any benefit would be small given the very small scale of the tax cuts from the perspective of the size of all business expenses.
 - With most of these cuts occurring at a time of a booming Arizona economy, any economic stimulus created by the cuts would have resulted in an increase in the importation of labor to the state and thus a rise in government expenditures.
- 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.

TAX CUTTING IN ARIZONA: EMPIRICAL BASIS

- In the last 30 years, Arizona has had two periods of tax reductions and one period of tax increases. The net result, especially since the early 1990s, has been to significantly lower the tax burden.
- The tax increases and reductions of the last 30 years have not had any obvious effect on the economy — on either aggregate or per capita/per worker bases.
 - Government revenue, however, has been lowered by tax cuts and raised by tax increases.
- When the economy is strong, surpluses in the general fund are realized, allowing taxes to be cut. When the economy is weak, budget deficits occur, precluding tax cuts and sometimes resulting in tax increases.
- The change in economic performance has slightly preceded the change in taxes.
- Despite the significant decline in Arizona's tax burden relative to other states since the mid-1990s, economic growth in Arizona relative to the nation in recent years has not been stronger than the historical relationship.

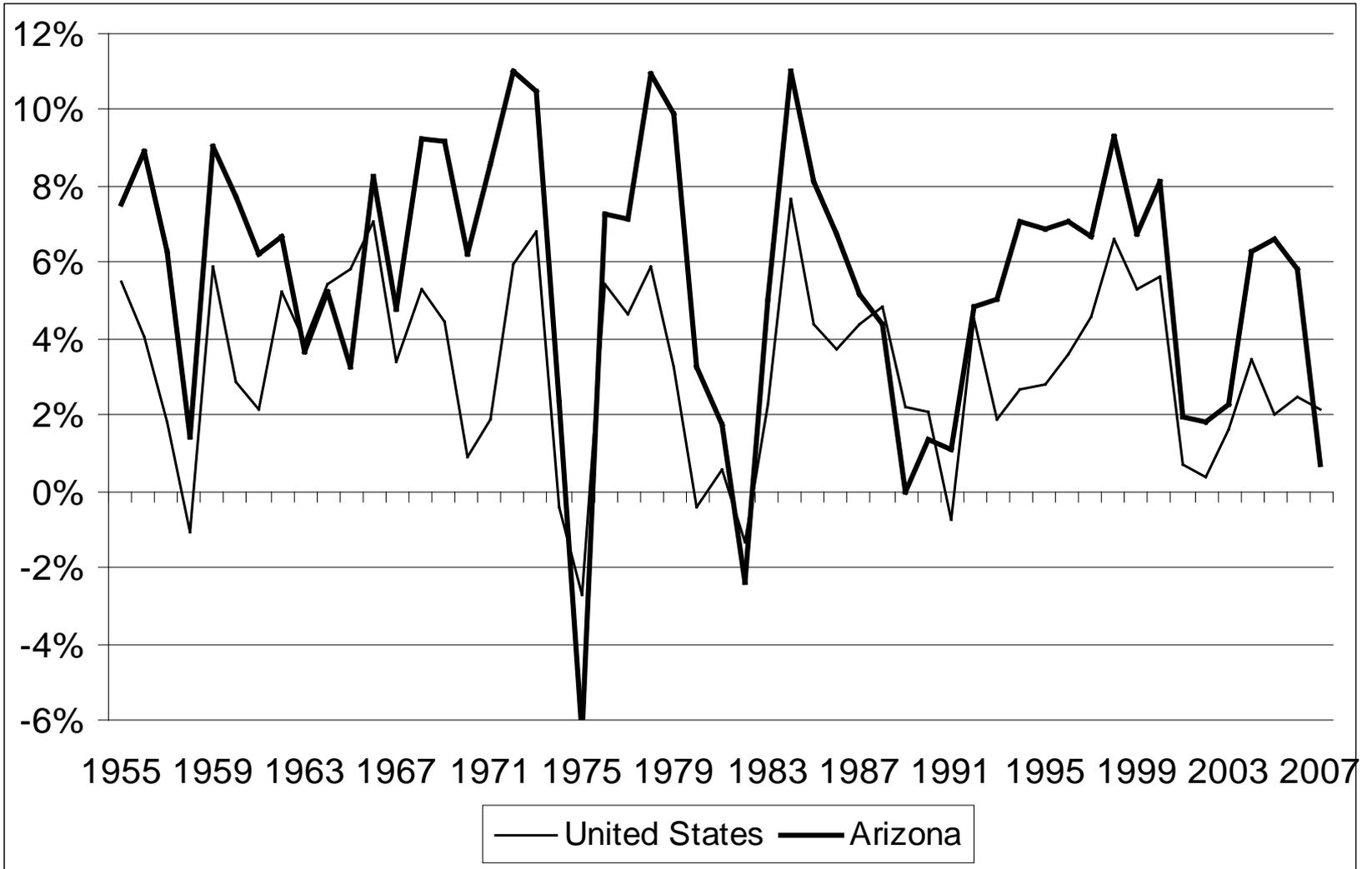
TAX CUTTING MYTHS

- **MYTH: All tax cuts are good for government revenue.** The idea that every tax cut will result in greater government revenue is a distortion of supply-side economics, which was popularized by the Laffer Curve. In reality, any cut in a tax rate that is already below the revenue-maximizing rate will result in lesser government revenue. Most of the reduction in taxes over the last 15 years in Arizona has been to the individual income tax, which had a tax rate below the national norm prior to the first tax cut. Over the last 30 years in Arizona, tax increases have resulted in greater public-sector revenue and tax cuts have led to lesser government revenue.
- **MYTH: All tax cuts enhance economic growth.** Empirical evidence to support this statement has not been found. In Arizona, tax increases and decreases over the last 30 years have had no perceptible impact on economic growth.

ECONOMIC CYCLES AND GOVERNMENT REVENUE

- Economic cycles have been a feature of human society for at least hundreds of years.
- The timing of economic cycles in Arizona is similar to the nation, but the magnitude of swings in economic growth is much greater in Arizona.
- Government revenue goes up and down with economic cycle.
- Arizona state government general fund revenue has been much more volatile than economic growth.
- Revenue growth during the last decade has been extremely cyclical, but economic fluctuations have been typical.
 - Revenue cyclicalities is in part due to the narrowing of the tax base since the mid-1990s – a side effect of a long series of tax cuts.
 - Extreme cyclicalities of capital gains has resulted in unusually volatile income tax collections.

HISTORY OF ECONOMIC CYCLICALITY: ANNUAL PERCENT CHANGE IN REAL EARNINGS



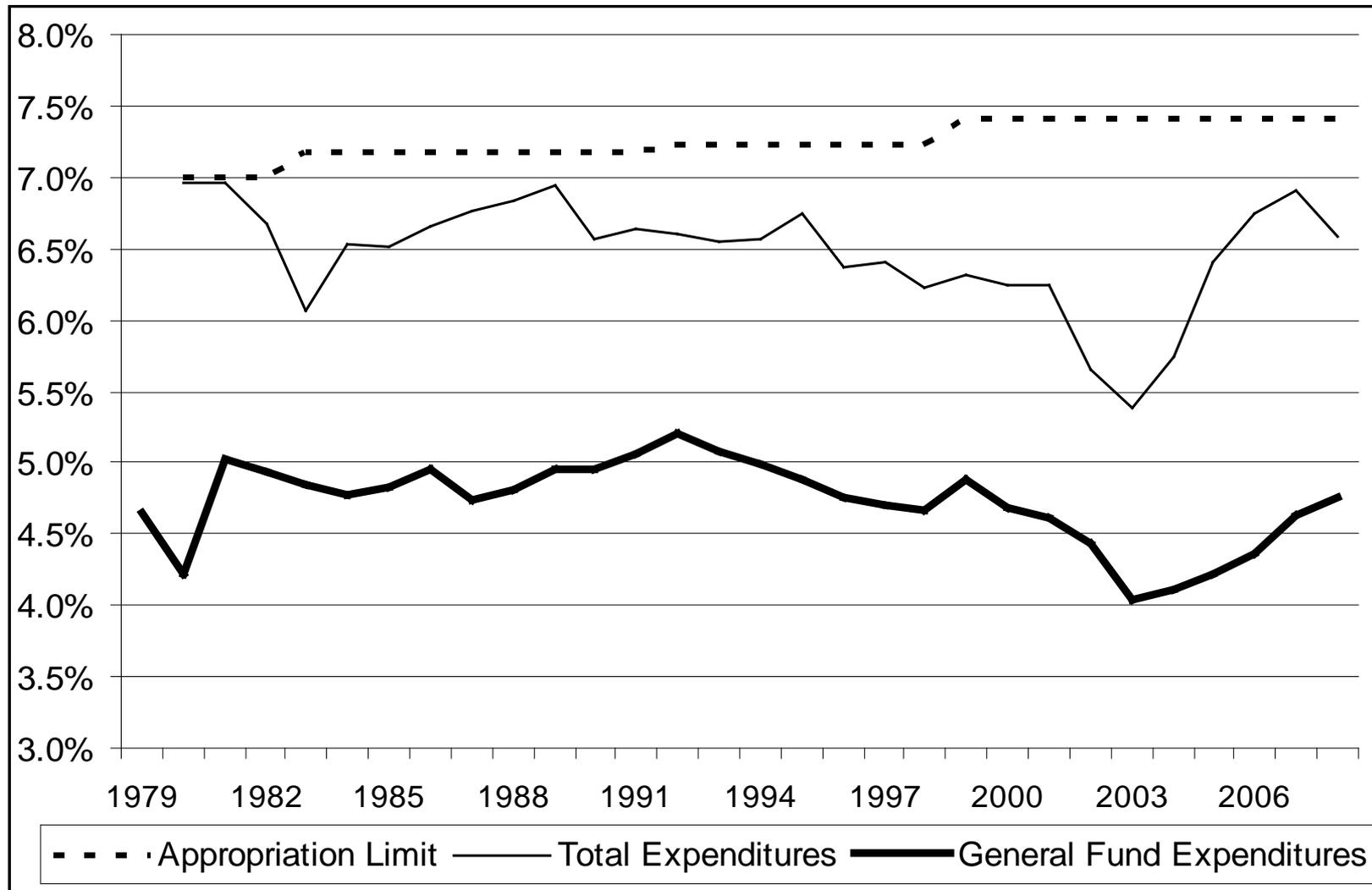
ARIZONA GENERAL FUND REVENUE AND ECONOMIC GROWTH: ANNUAL PERCENT CHANGE IN REAL PER CAPITA DOLLARS



TAX AND EXPENDITURE LIMITATIONS (TEL)

- Arizona already has a TEL. The Arizona Constitution states that “The legislature shall not appropriate for any fiscal year state revenues in excess of seven percent of the total personal income of the state ...” Spending has never reached this limit.
- Some Arizonans have proposed limiting annual increases in government spending to the pace of population growth and inflation.
 - This represents an extreme form of a TEL. The purpose of such a measure is to shrink the size of government over time — meaning that the quality and/or quantity of public services will erode over time.
- Rather than limiting government spending increases to population growth and inflation, Arizona’s existing TEL also considers the rate of real per person economic growth, which in essence is a measure of productivity growth.
- When real per person income advances, government spending can rise without any increase in the tax burden.

EXPENDITURES AND CONSTITUTIONAL APPROPRIATION LIMIT AS A PERCENTAGE OF PERSONAL INCOME ARIZONA STATE GOVERNMENT



TAX AND EXPENDITURE LIMITATIONS

- Without the ability to increase spending beyond the rate of population growth and inflation, a state can never improve the quality of its public services.
- Had this spending restriction been adopted at statehood in 1912, Arizona's physical infrastructure and other public services in 2009 would resemble those of 1912: dirt roads, no modern communication, limited water and wastewater services, school houses with no computers, no airports, etc.
 - Few businesses would consider operating with such an inadequate infrastructure and few individuals would choose to live in what now would be seen as Third-World conditions.
- Had the alternative been implemented in 1979 (when the existing TEL was put into effect), and had the TEL applied to all governments in Arizona (like TABOR in Colorado), then total government spending in 2006 in Arizona would have been \$15.4 billion (43 percent) less than the actual figure.
 - Arizona's spending would have been last in the nation — 41 percent less on a per capita basis and 33 percent less relative to personal income than the next lowest state!

PART II: PUBLIC FINANCE IN ARIZONA

State Government

HISTORY OF TAX LAW CHANGES

- Despite the need for stable, if not increasing, funding during recessions, ever since the first round of tax cuts in the 1979-to-1981 period, general fund revenue during economic downturns has been inadequate to meet the expenditure needs.
- The net effects of tax law changes passed by the Arizona Legislature since 1992 have cumulated to \$1.6 billion per year in lost revenue on a nominal basis, according to the Arizona Joint Legislative Budget Committee.
 - Considering inflation and population growth, the cumulative figure becomes nearly \$2.6 billion.
- The long series of state government tax cuts in Arizona have resulted in a structural budget deficit in the state's general fund.
 - This deficit has been caused not just by lowering tax rates, but by narrowing the tax base and by causing the revenue system to be less responsive to economic growth, resulting in revenue collections falling behind over time.
 - In addition, the tax cuts have made revenues more cyclical.

ESTIMATED DOLLAR VALUE OF TAX CHANGES ARIZONA STATE GOVERNMENT GENERAL FUND

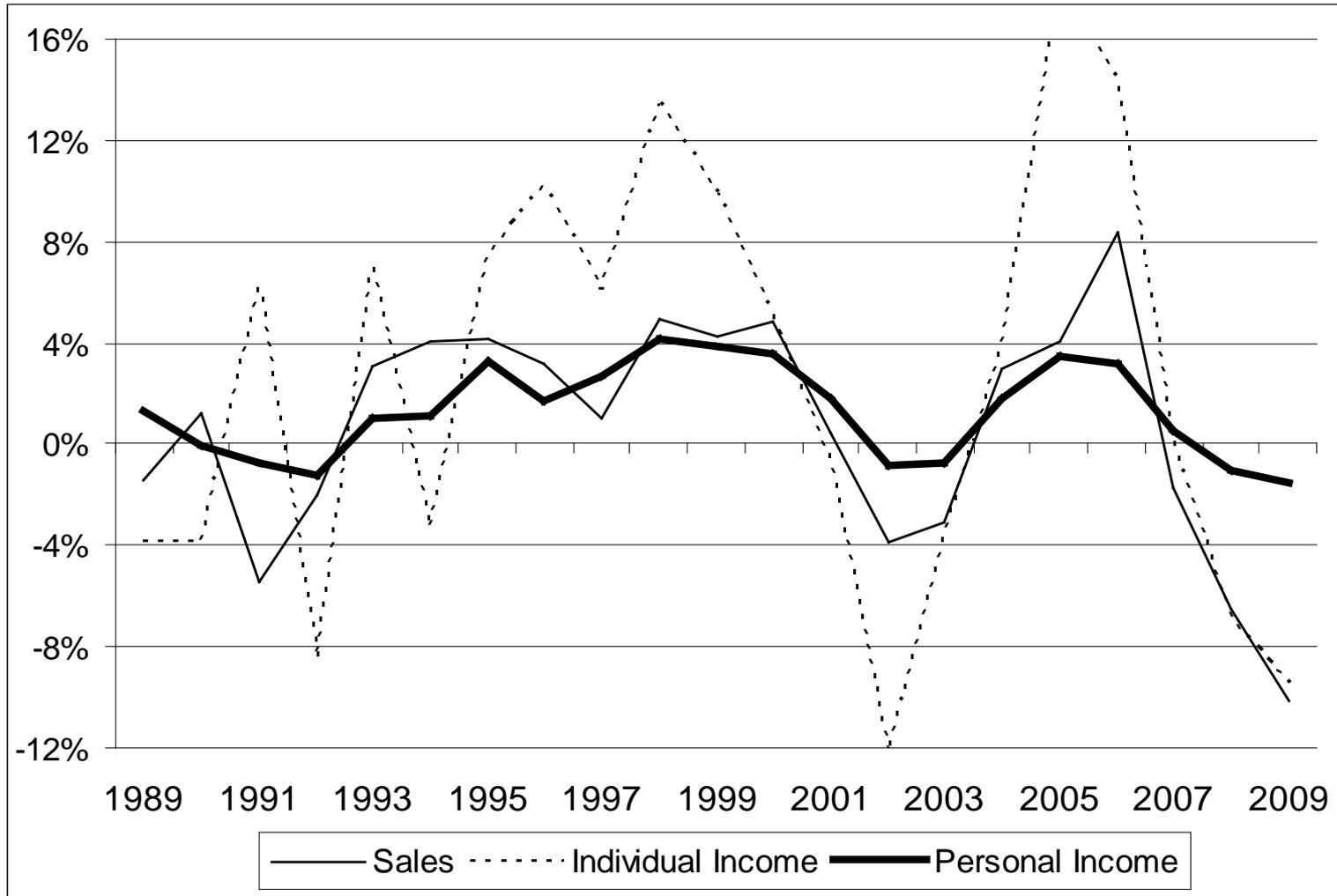
Fiscal Year	Tax Change in Millions	
	Annual	Cumulative
1993	-19	\$-19
1994	-25	-44
1995	-121	-165
1996	-285	-450
1997	-175	-625
1998	-172	-797
1999	-142	-939
2000	-105	-1,044
2001	-158	-1,202
2002	-33	-1,235
2003	12	-1,223
2004	57	-1,166
2005	-5	-1,171
2006	-18	-1,189
2007	-194	-1,383
2008	-218	-1,601
2009	-35	-1,636
2009 *		-2,579

* Adjusted for inflation and population growth

GENERAL FUND REVENUE: NARROW BASE AND VOLATILE

- The general fund of Arizona state government has a very narrow revenue base. Half of the revenue in FY 2008 came from sales and use taxes, and 40 percent came from income taxes.
- The base was broader before the mid-1990s — before the general fund portions of the property and vehicle license taxes were eliminated.
- Collections from the two major revenue sources are highly cyclical.
 - Individual income tax collections have been much more cyclical than sales tax collections, except that the current decline in sales tax revenue is matching that of the individual income tax.
 - The cyclicity of the corporate income tax is far greater than the individual income tax.

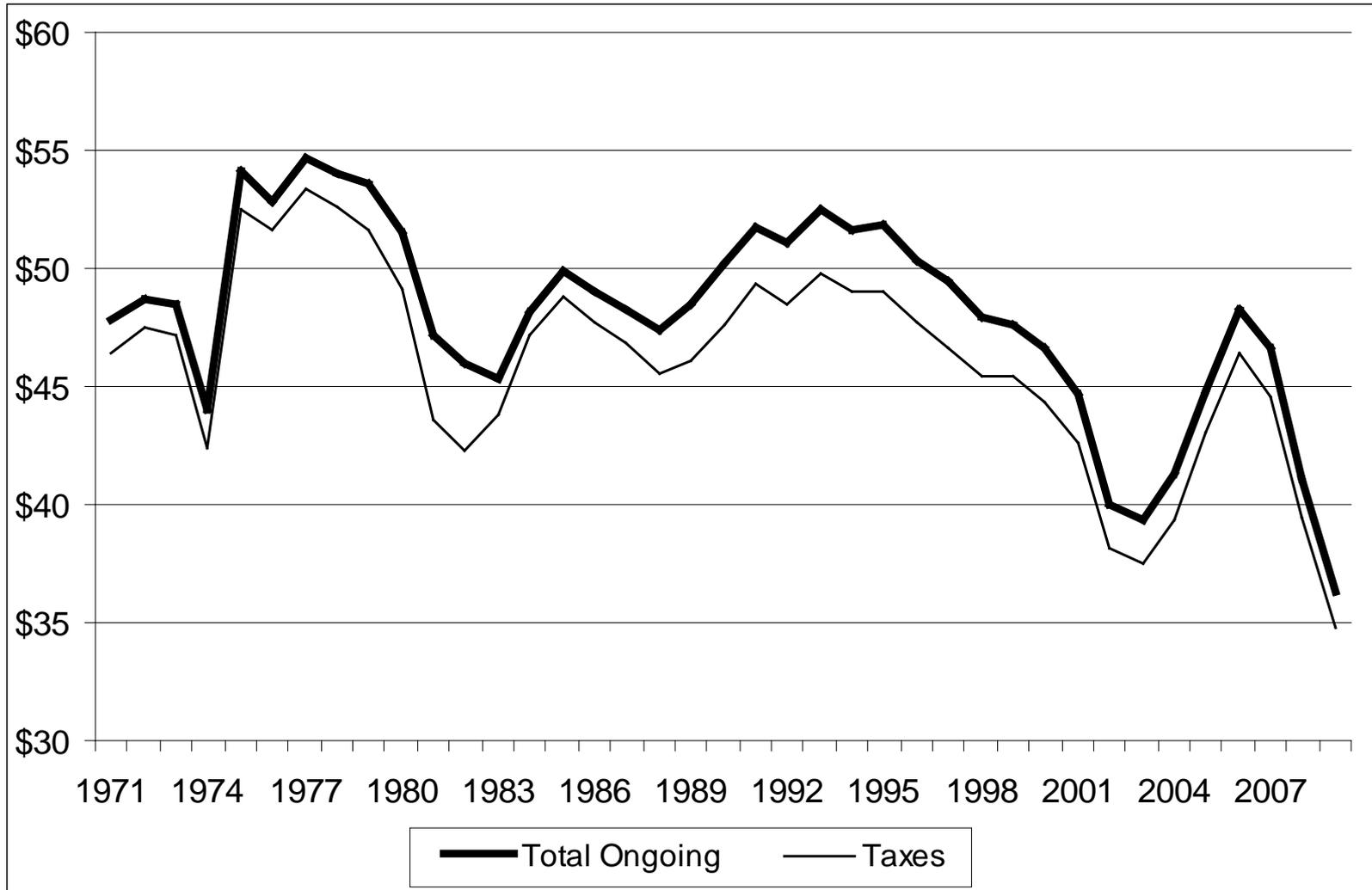
MAJOR SOURCES OF ARIZONA GENERAL FUND REVENUE AND ECONOMIC GROWTH: ANNUAL PERCENT CHANGE IN REAL PER CAPITA DOLLARS



GENERAL FUND REVENUE: FALLING RELATIVE TO SIZE OF ECONOMY

- General fund revenue per \$1,000 of personal income was highest in the late 1970s, prior to the first round of tax cuts.
- A sharp downward trend is obvious since the early 1990s.
 - This is strong evidence of the lack of a supply-side effect from the tax cuts.
- Arizona state government general fund revenue per \$1,000 of personal income is at a record low in the current fiscal year.
- Nine of the 12 lowest figures over the 39-year history have occurred during the last 10 years — only at the peak of the economic cycle in FY 2006 was revenue per \$1,000 comparable to the historic norm.

ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE PER \$1,000 OF PERSONAL INCOME



BUDGET STABILIZATION FUND

- The budget stabilization fund (BSF) is intended to transfer monies to the general fund at times when revenue declines due to cyclical factors.
 - A rainy-day fund is needed because government revenue drops during a recession while demand for public services continues to increase.
- Continued public spending during a recession using rainy-day 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.
- The amount of money placed in the BSF has been highly inadequate to close the deficits during the two economic downturns since the BSF was created.
 - The Legislature reduced the cap from 15 percent to 7 percent.
- The early depletion of the budget stabilization fund in each of the recessions indicates both that a structural deficit exists due to tax cuts not being matched by spending reductions and that the design of the rainy-day fund is not adequate.

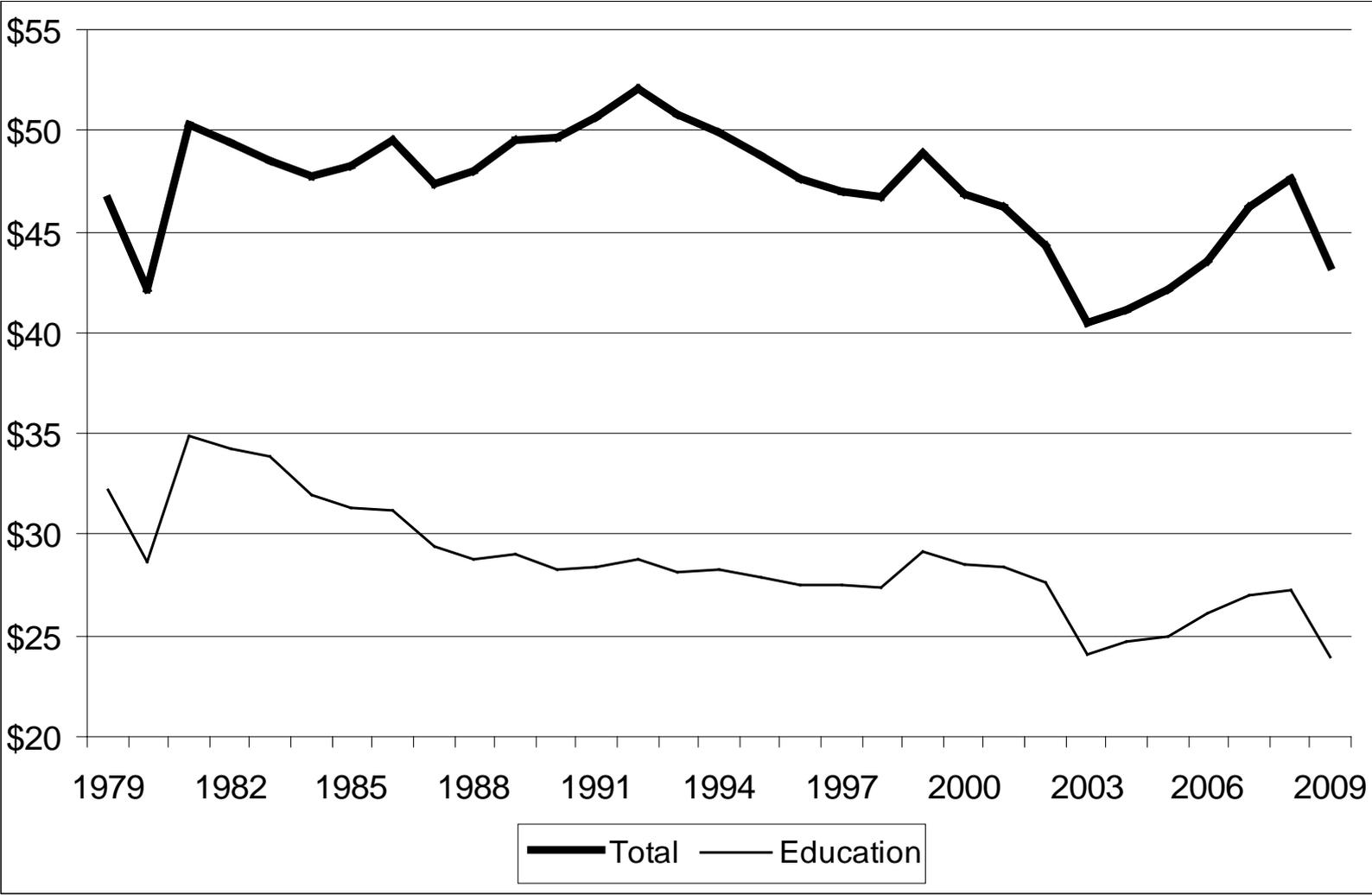
GENERAL FUND EXPENDITURES BY TYPE

- More than half of the funding goes to education.
 - K-12 education is by far the largest use. Much of this funding is protected by voter initiative.
 - The universities continue to receive a declining share of the general fund and represent the second-largest category of unprotected spending.
- Much of the spending in the health and welfare category, the second-largest use of state general fund monies, is protected or mandated.
- The protection and safety category is the other major recipient of state general fund monies.
 - With none of the spending for the Department of Corrections and the Department of Juvenile Corrections voter protected, this is the largest recipient of unprotected funding.
- While much of the rest of the state budget is unprotected, relatively little money is at stake.

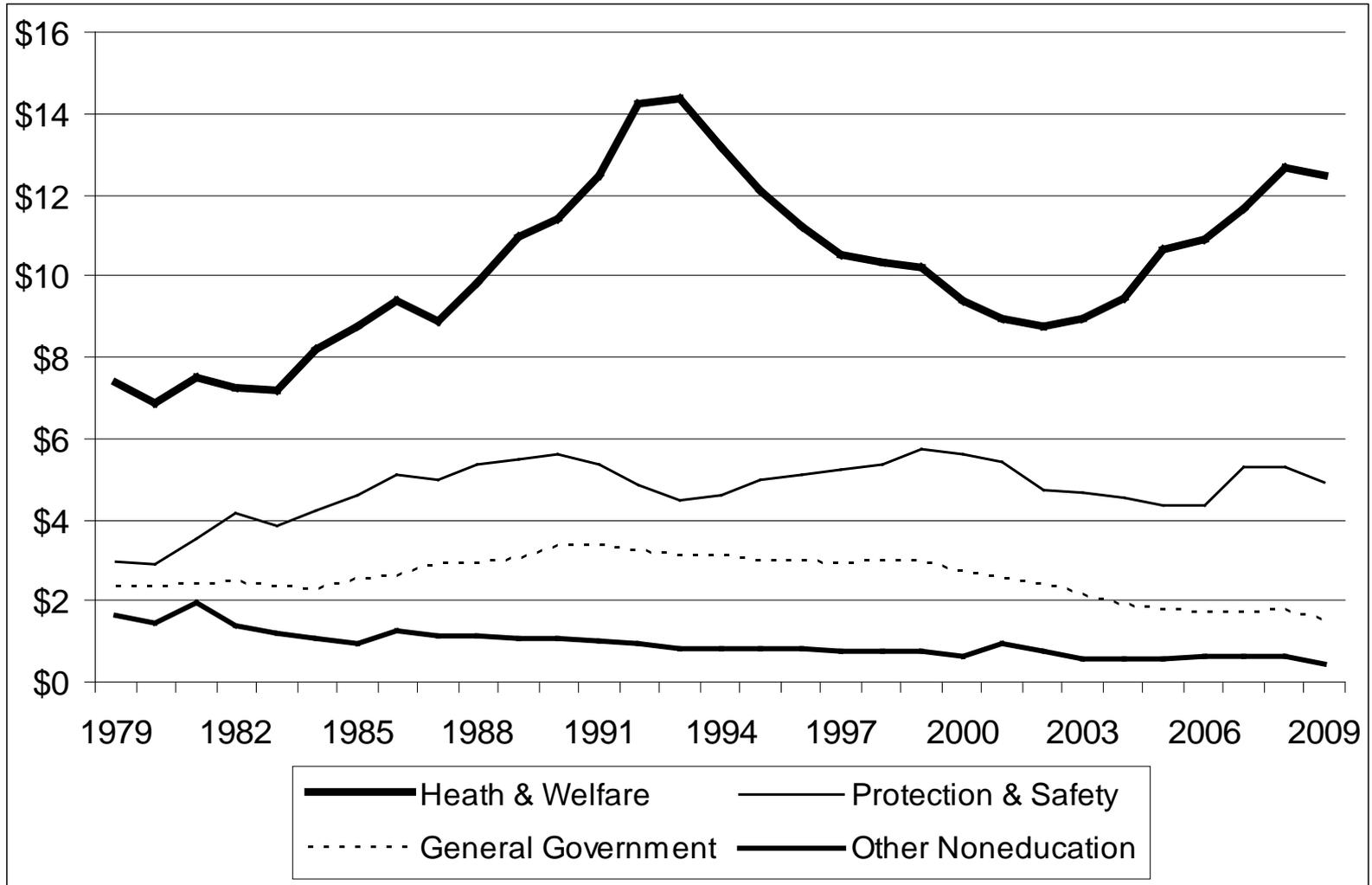
GENERAL FUND EXPENDITURES: FALLING RELATIVE TO SIZE OF ECONOMY

- Arizona state government general fund expenditures per \$1,000 of personal income have fallen since the early 1990s.
- At the peak of the current cycle in FY 2008, expenditures per \$1,000 of personal income were 17th highest of the last 31 years.
- While the FY 2008 figure was up considerably from the FY 2003 figure, expenditures in FY 2003 were at a record low due to the spending cuts implemented at that time in order to balance the general fund during the last economic downturn.
- The FY 2009 figure is the second lowest of the 31-year history other than the 2003-to-2005 period.
- Per \$1,000 of personal income, expenditures for education have fallen for more than 25 years. In contrast, expenditures have increased substantially in the health and welfare category, and also have climbed in the protection and safety category.

EXPENDITURES PER \$1,000 OF PERSONAL INCOME: ARIZONA STATE GOVERNMENT GENERAL FUND



EXPENDITURES PER \$1,000 OF PERSONAL INCOME BY CATEGORY: ARIZONA STATE GOVERNMENT GENERAL FUND



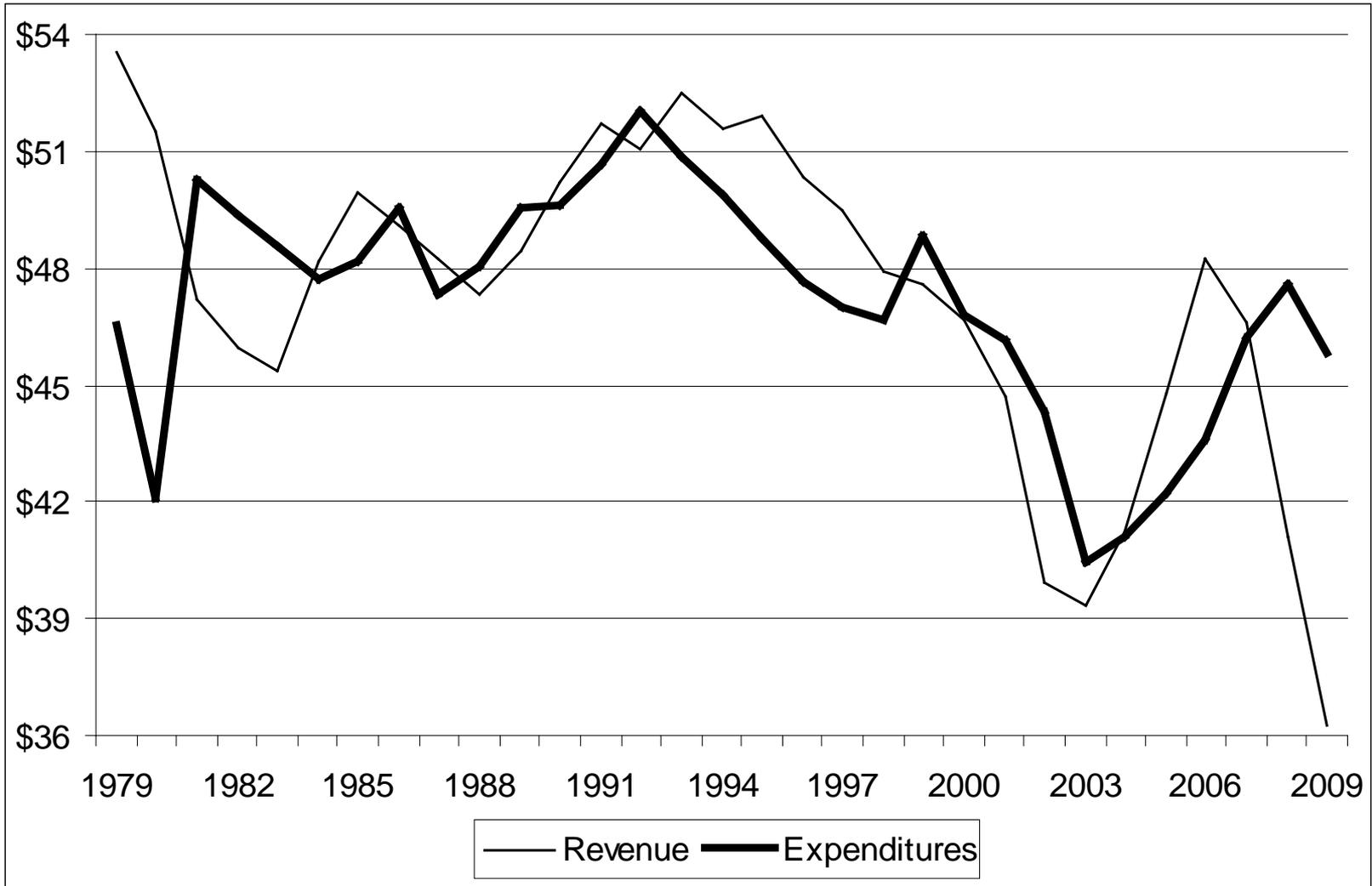
SPENDING MYTHS

- **MYTH: The state government budget deficit is due to “reckless” spending.** State government spending per \$1,000 of personal income in fiscal year 2008 was 17th highest of the last 30 years.
 - Spending did increase considerably between FYs 2003 and 2008, but the FY 2003 figure was the lowest on record, a result of severe spending cuts during the previous economic downturn.
- **MYTH: State government has plenty of “fat” to cut.** Over the last 15 years, expenditures per \$1,000 of personal income have fallen in education, which accounts for more than half of general fund expenditures. Public safety and public welfare are the only categories not to experience decreasing expenditures. Most of the increase in public welfare has been mandated by the federal government and by Arizona voter initiative.

SIMULATED BUDGET DEFICIT

- The current budget deficit consists of two parts: a cyclical portion resulting from a sharp decline in revenue due to the economic recession and a structural portion resulting from 15 years of tax cuts.
 - An increase in state government general fund spending has not contributed to the large budget deficits of the last two economic downturns.
- The cyclical portion of the projected deficit for FY 2010 of \$3 billion accounts for less than \$1 billion. Thus, the structural deficit accounts for the majority of the deficit.
- Had no tax cuts been implemented after 1992 and had expenditures been at the historic norm per \$1,000 of personal income, revenue would have exceeded expenditures in FY 2008 but would have fallen about \$629 million short of expenditures in FY 2009.
 - All of this would have been covered by transfers from the budget stabilization fund.
- The shortfall of just more than \$400 million in FY 2010 would have been easily covered by the federal stimulus funds.
 - No spending cuts, sweeps of other funds, or revenue enhancements would have been necessary.

ONGOING REVENUE AND EXPENDITURES PER \$1,000 OF PERSONAL INCOME: ARIZONA STATE GOVERNMENT GENERAL FUND



CURRENT BUDGET DEFICIT

- The actual budget deficit for FY 2010 is projected to be \$3 billion.
- Assuming that the February 2009 spending reductions of nearly \$600 million in the current fiscal year will continue, the state government general fund shortfall in the next fiscal year is projected to be \$2.4 billion.
- Temporary federal assistance of perhaps \$1.3 billion will be available.
- In addition, fund transfers of more than \$300 million are projected to be available.
- This would leave less than a \$1 billion shortfall that would need to be closed through spending reductions and/or revenue enhancements.
- The Governor has proposed a temporary tax increase of \$1 billion.
- Even without further spending reductions, general fund appropriations still will be close to \$1 billion less than the long-term norm in FY 2010.

THE DEFICIT FROM A NATIONAL PERSPECTIVE

- According to the Center on Budget and Policy Priorities, Arizona's budget shortfalls in the current and following fiscal years are the largest in the nation as a percentage of the general fund.
 - Arizona's 16 percent deficit in FY 2009 is the largest of any state.
 - Its projected FY 2010 deficit of 30 percent is tied with Nevada as the highest of any state at nearly twice the average.
- Arizona also had a disproportionately large deficit in the last economic downturn.
- While Arizona's economy has been disproportionately affected by the negative economic conditions, this is not the only reason for its extremely large deficit. The sizable tax cuts of the last 15 years introduced a structural deficit.
- In large part due to the structural deficit, Arizona was not rated favorably in "Grading the States 2008," published by Governing magazine. In the "money" category, Arizona was assigned a grade of C+. However, 30 states received a higher grade and only eight received a lower grade.

PART II: PUBLIC FINANCE IN ARIZONA

**State and Local Government
Combined**

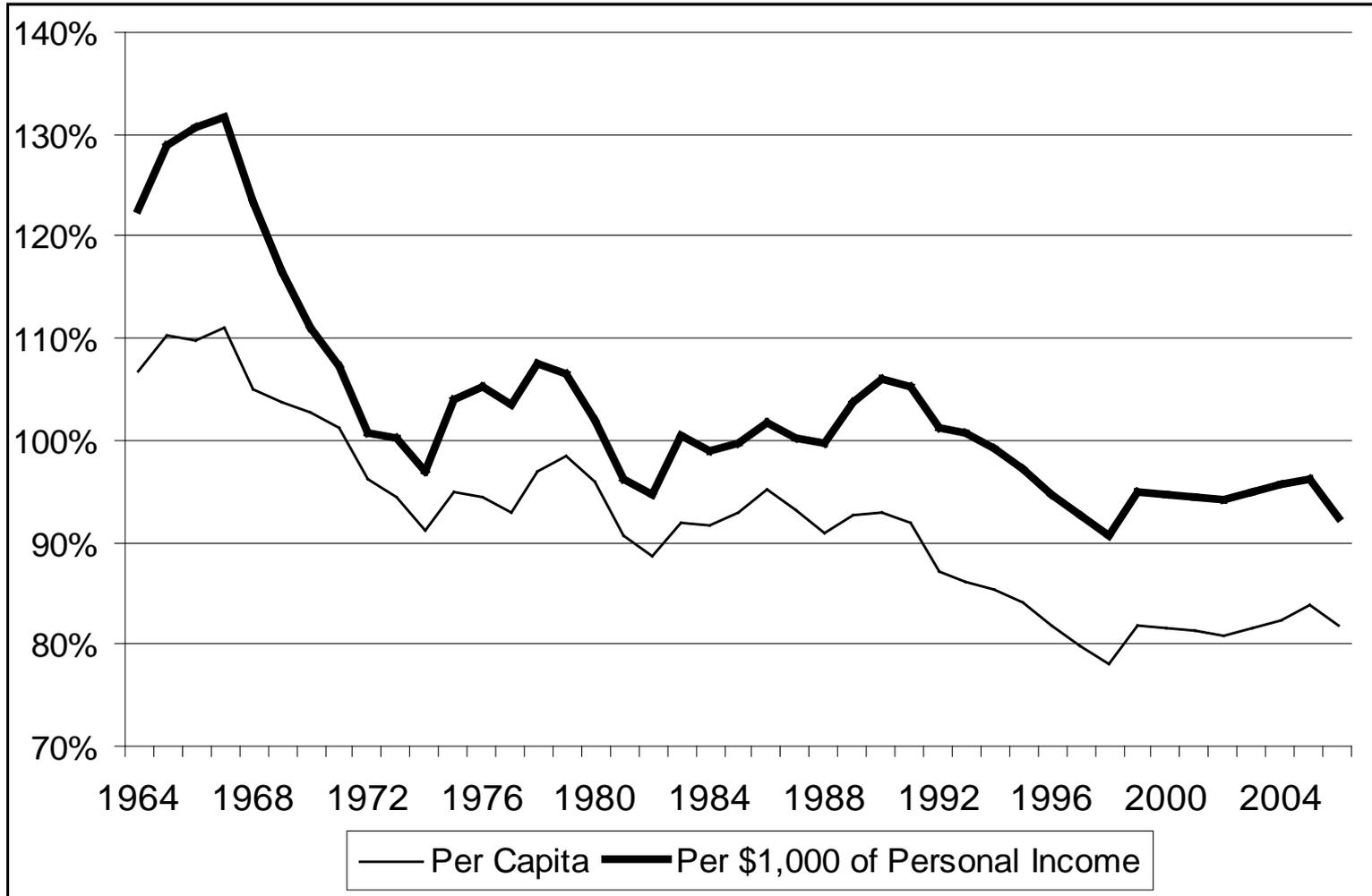
REASON FOR INCLUDING LOCAL GOVERNMENTS

- To compare government finance in Arizona to other states, state and local government figures must be combined, since the level of government levying taxes and fees and having responsibility for funding programs varies from state to state.
- This cross-state comparison reveals that not only has government revenues and expenditures relative to the size of the economy declined over time in Arizona, they have decreased relative to the national average.
- Arizona's revenue and expenditure ranks among all states and among a smaller group of fast-growing and/or western states also have fallen.

STATE AND LOCAL GOVERNMENT REVENUE

- Total state and local government general revenue in Arizona in FY 2006 was 18 percent less than the national average on a per capita basis, second lowest in the nation.
- Per \$1,000 of personal income, Arizona's figure was 7.5 percent below average. The state ranked 39th among the 51 "states" and ninth among 13 western and/or fast-growing states.
- Arizona state and local government revenue per \$1,000 of personal income has been at historic lows since the early 1990s — far below the figures of the 1960s and below the norm of the period from the 1970s into early 1990s.
 - Arizona's figure has been less than the U.S. average since the mid-1990s.
- If not for revenue received from the federal government, Arizona would rank even lower per \$1,000 of personal income: 45th nationally and next-to-last in the comparison group on own-source revenue (tax and nontax revenue combined).
 - Own-source revenue was 12 percent less than the national average in FY 2006; prior to FY 1995, it had been average or above average in each year.

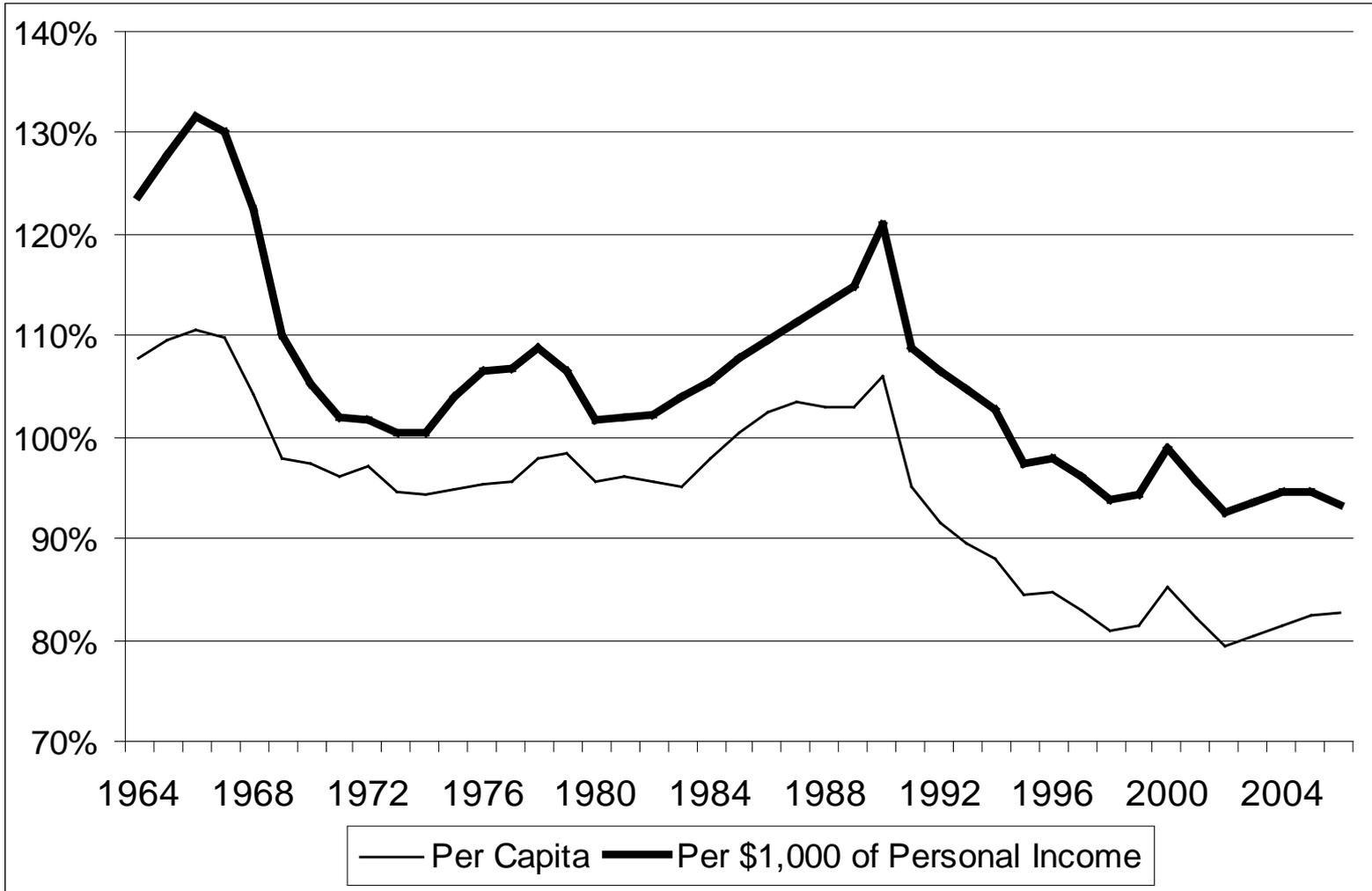
GENERAL REVENUE AS A PERCENTAGE OF THE NATIONAL AVERAGE: ARIZONA STATE AND LOCAL GOVERNMENTS



STATE AND LOCAL GOVERNMENT EXPENDITURES

- Total state and local government general expenditures in Arizona in FY 2006 were 17 percent less than the national per capita average, fifth lowest in the nation and third lowest among 13 western and/or fast-growing states.
- Per \$1,000 of personal income, Arizona's figure was 7 percent below average. The state ranked 36th among the 51 states and ninth among the comparison states, down from 21st and fifth, respectively, in FY 1992.
- As a percentage of the national average, total expenditures per capita and per \$1,000 of personal income have fallen since the early 1990s in Arizona. The ratios since the mid-1990s have been the lowest on record.
 - Per \$1,000 of personal income, Arizona's figure has been around 95 percent of the national average since the late 1990s; prior to FY 1995, the Arizona figure always had been higher than average.
 - Similarly, Arizona's per capita spending figure has been at least 15 percent less than average since the late 1990s, but historically ranged from 5 percent below to above the national average.

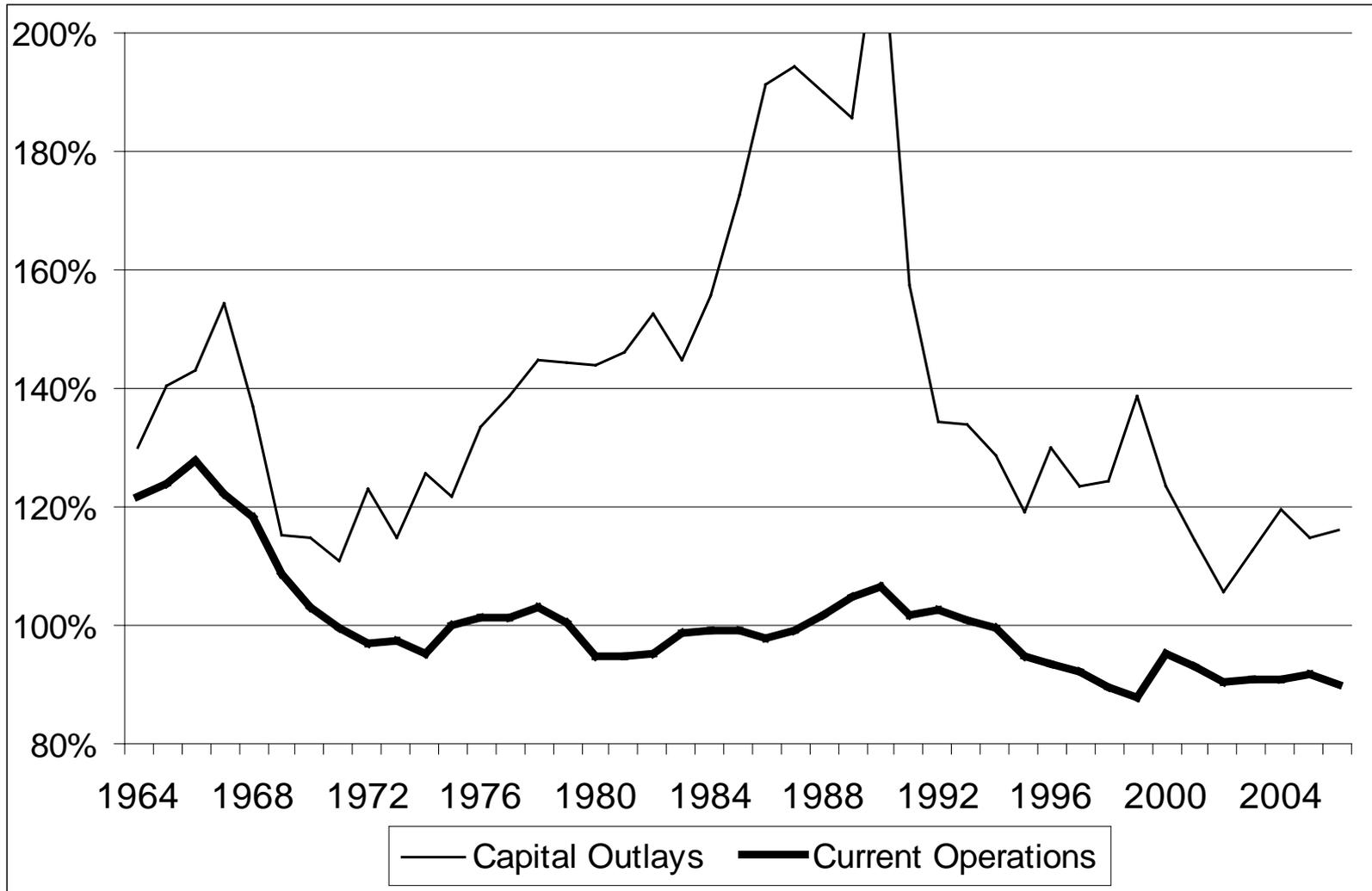
GENERAL EXPENDITURES AS A PERCENTAGE OF THE NATIONAL AVERAGE: ARIZONA STATE AND LOCAL GOVERNMENTS



CAPITAL OUTLAYS VERSUS CURRENT OPERATIONS

- Overall expenditures are subdivided into capital outlays and current operations. A capital outlay is defined as a public expenditure for construction, the purchase of land and existing structures, and the purchase of equipment.
 - The state's rapid population growth causes above-average needs for capital spending.
- All other expenditures are classified as current operations.
- Though capital outlays are down considerably from the historic norm, the state's capital spending still is above the national average.
- Spending on current operations is far below the national average and below the historical norm.
 - Arizona's current operations spending per \$1,000 of personal income in FY 2006 ranked 42nd in the nation and 10th among the 13 comparison states.
 - On a per capita basis, current operations spending was second lowest in the country.

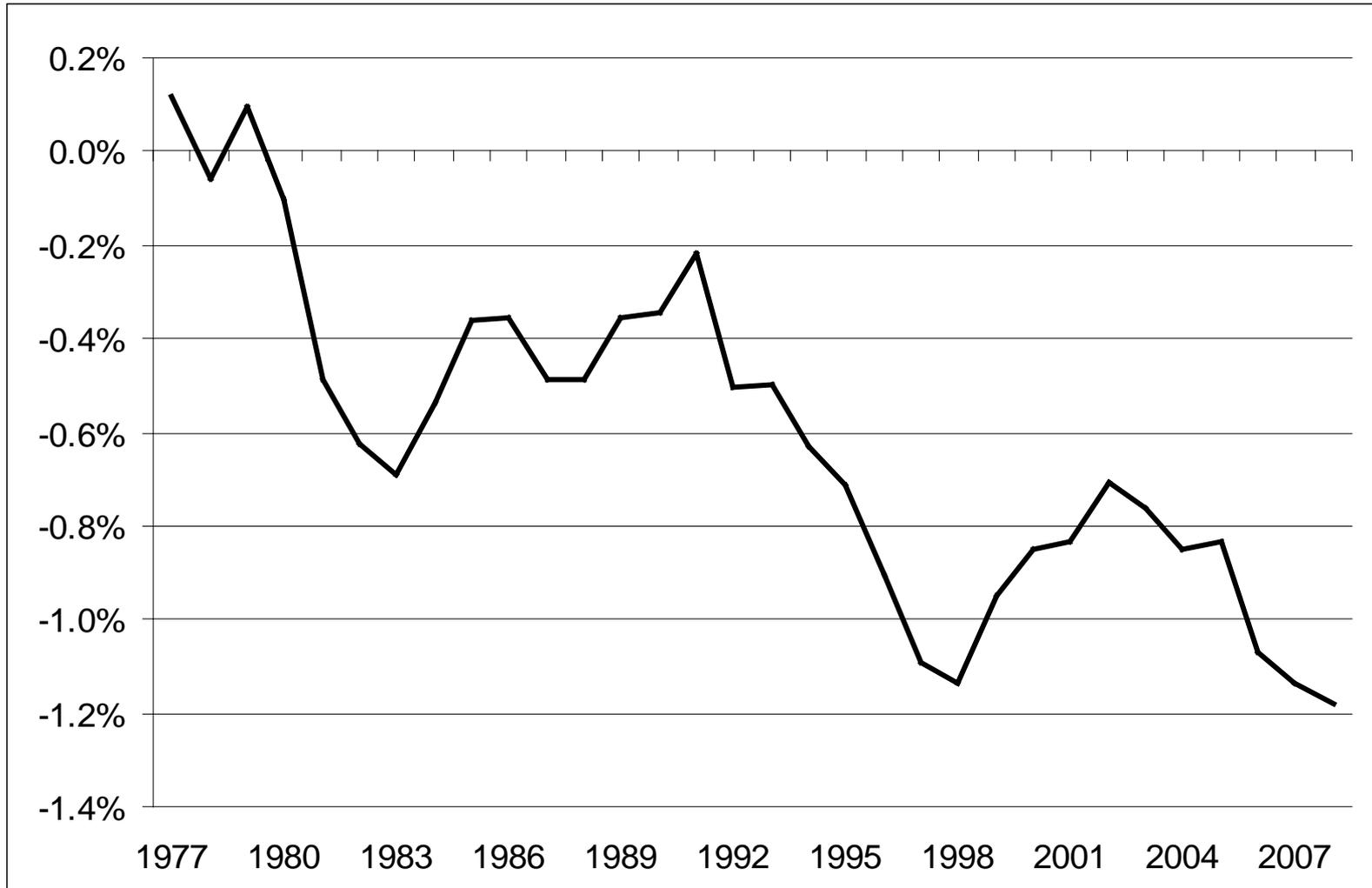
GENERAL CURRENT OPERATIONS SPENDING AND CAPITAL OUTLAYS PER \$1,000 OF PERSONAL INCOME AS A PERCENTAGE OF THE NATIONAL AVERAGE: ARIZONA STATE AND LOCAL GOVERNMENTS



TAX BURDEN

- As calculated by the Tax Foundation, the state and local government tax burden in Arizona — defined as per capita taxes as a share of per capita income — has dropped considerably since 1977, particularly since the early 1990s.
 - Arizona's rank has fallen from 17th to 41st.
- The 2007 District of Columbia study indicates that the overall tax burden in Phoenix was substantially below the norm except in the lowest income category. The income tax and property tax burdens were quite low, the sales tax burden was very high, and the automobile taxes were close to the norm except at the higher incomes.
- **MYTH: The tax burden in Arizona is high and rising.** According to the Tax Foundation, the combined state and local government tax burden in Arizona in 2008 is 12 percent less than the national average. Arizona ranks 41st among the 50 states, the lowest rank on record.

TAX FOUNDATION TAX BURDEN IN ARIZONA RELATIVE TO NATIONAL AVERAGE: STATE AND LOCAL GOVERNMENT TAXES



2007 DISTRICT OF COLUMBIA TAX BURDEN STUDY: STATE AND LOCAL GOVERNMENT TAXES IN PHOENIX, ARIZONA

	Household Income				
	\$25,000	\$50,000	\$75,000	\$100,000	\$150,000
Rank Among 51 'States'					
Income Tax	25	38	39	41	41
Property Tax	*	43	42	42	42
Sales Tax	2	2	2	1	2
Automobile Taxes	27t	24t	17	17	13
Total Taxes	17	42	44	42	41
Total Taxes as a Percentage of Income					
Total	12.6%	6.8%	6.8%	7.2%	6.9%
Difference from Average State	0.7	-2.0	-1.9	-1.7	-2.1
Difference from Median State	1.2	-2.0	-1.7	-1.7	-2.4

* Tax assumed to be equal in all states.

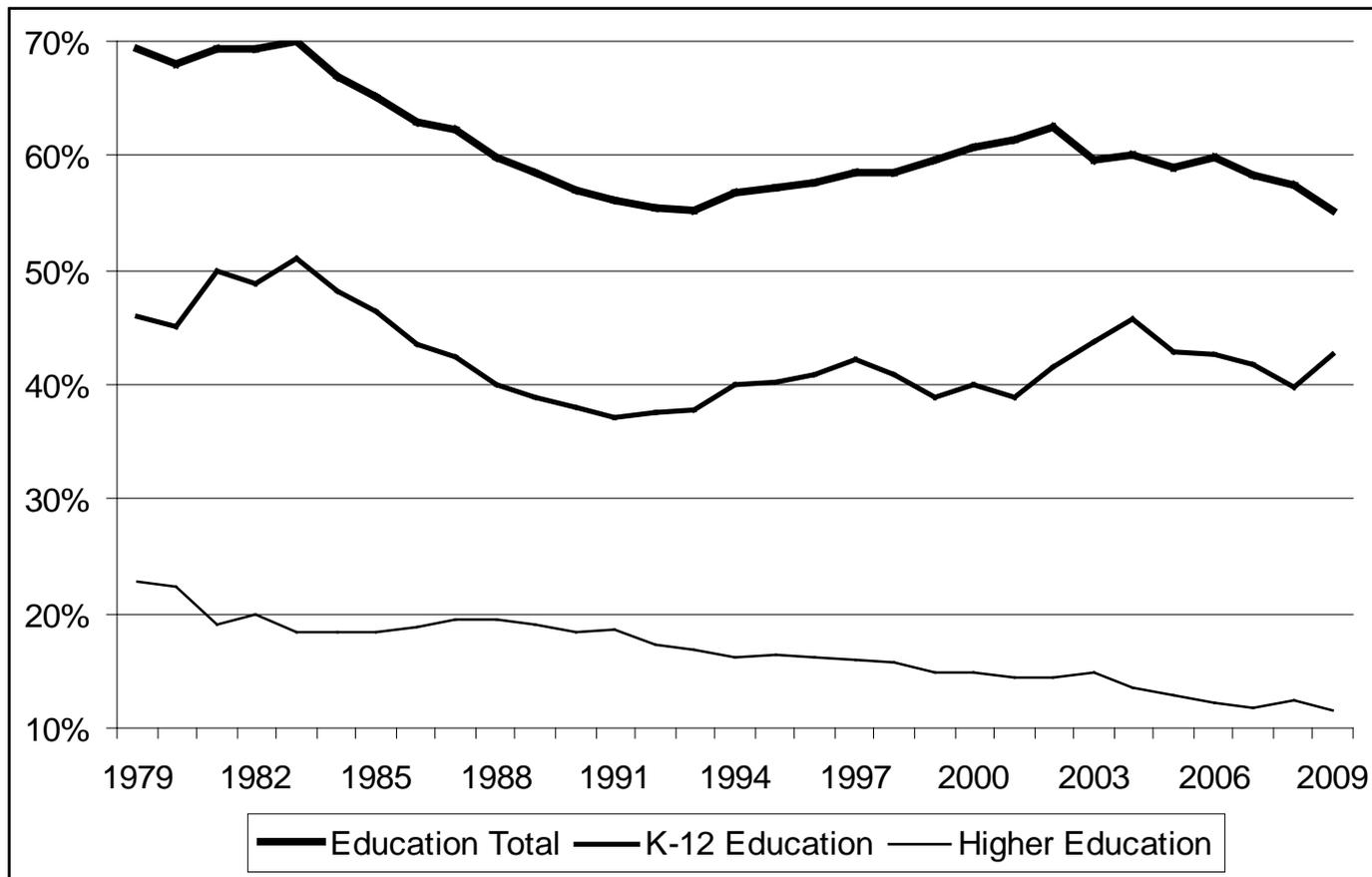
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PART III: EDUCATION IN ARIZONA

REASONS FOR HIGHLIGHTING EDUCATION

- Education received 55% of the general fund appropriations in 2009.
 - But this share has declined over time, particularly for higher education.

EDUCATION EXPENDITURES AS A SHARE OF THE ARIZONA STATE GOVERNMENT GENERAL FUND



REASONS FOR HIGHLIGHTING EDUCATION

- Education is very important to the economy.
 - The educational attainment of a region's workforce and the quality of a region's educational system are of key importance to a region's economic development.
 - In addition to the monetary societal benefits of enhanced educational attainment, regions with greater shares of educated workers, especially highly educated workers, experience lower crime rates, fewer demands on social services, greater civic participation, and improved personal health.
- Disproportionate cuts to higher education have been made.
 - The FY 2009 reductions passed in early February account for just less than 6 percent of the total general fund, but the reduction to the university system is 13 percent. The spending reduction options presented for FY 2010 amount to 20 percent of the total general fund but nearly 30 percent of the university system budget.
 - Like most of the public sector, the demand for university services does not drop during recessions. Therefore, any reduction in funding for universities will have a negative and direct effect on students.

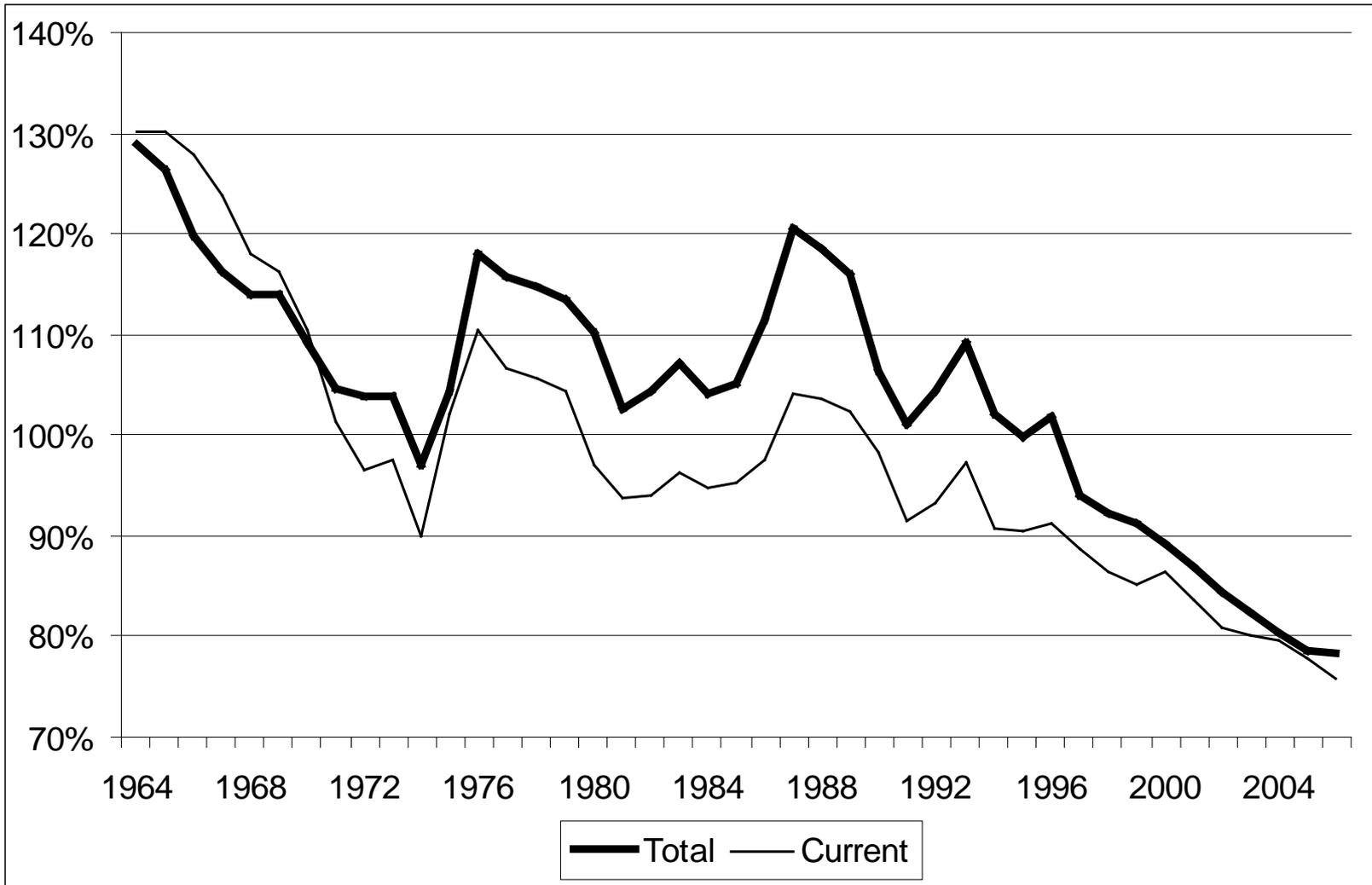
EDUCATION EXPENDITURES

- A disproportionately high share of Arizona's children face demographic challenges that have been shown to adversely affect educational achievement, including high poverty rates, low educational attainment of their parents, and lesser frequency of full-time, year-round employment of their parents.
- In addition, a disproportionately large number of Arizona's children are English-language learners.
- All else equal, for the state's students to realize achievement levels equal to the national average, these demographic challenges mean that the state's education funding per pupil needs to be greater than the national average.
- Instead, per student public funding for education — total current operations spending from all funds by all state and local governments, as reported by the U.S. Census Bureau — is among the lowest in the country in Arizona.
- Expressed per student per \$1,000 of personal income, funding has dropped over time, relative to past spending in Arizona and particularly relative to the change in spending over time in other states.

K-12 EDUCATION FUNDING

- Current operations funding for elementary and secondary education in Arizona is very low compared both to other states and to Arizona's historical record. In the most recent year (FY 2006), with ranks calculated among the 50 states and the District of Columbia, K-12 education expenditures in Arizona ranked
 - 50th per capita at 27 percent less than the national average
 - 48th per \$1,000 of personal income (17 percent below average)
 - 50th on a per student basis (33 percent below average)
 - 51st per student per \$1,000 of per capita personal income (24 percent below average).
- K-12 spending in Arizona on each of these measures was above average in the 1960s and 1970s. Since then, public spending for elementary and secondary education has fallen increasingly far below the national average.
 - Depending on the measure, the state's rank fell between five and 14 places between 1993 and 2006, with the ratio to the national average dropping between 7 and 17 percentage points.

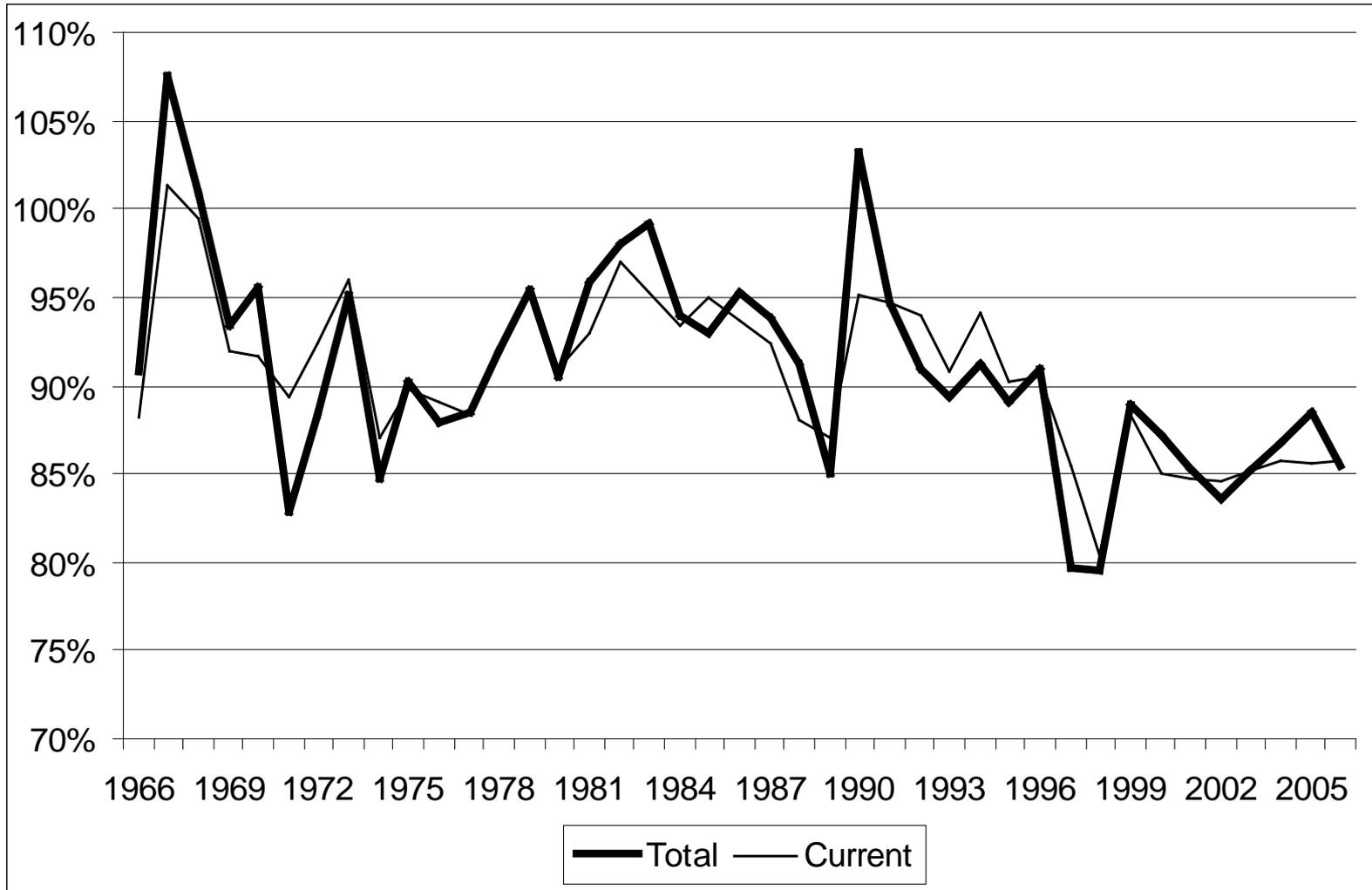
K-12 EDUCATION EXPENDITURES PER STUDENT PER \$1,000 OF PER CAPITA PERSONAL INCOME: ARIZONA STATE & LOCAL GOVERNMENTS AS A PERCENTAGE OF THE NATIONAL AVERAGE



HIGHER EDUCATION FUNDING

- Current operations funding for public institutions of higher education (community colleges and universities) is very low in Arizona compared both to other states and to Arizona's historical record. In FY 2006, with ranks calculated among the 50 states and the District of Columbia, Arizona ranked
 - 51st per student at 24 percent less than the national average
 - 46th on a per full-time-equivalent (FTE) student basis (13.5 percent below average)
 - 47th per student per \$1,000 of per capita personal income (14 percent below average)
 - 37th per FTE student per \$1,000 of per capita personal income (2 percent below average).
- Spending in Arizona per FTE student had been above average historically. Current operations expenditures for higher education per \$1,000 of personal income have decreased over time in Arizona, especially during the late 1960s and early 1970s.
- Another round of relative spending decreases has occurred since the early 1990s, with ranks falling a few more places and the ratio to the national average also dropping.

HIGHER EDUCATION EXPENDITURES PER STUDENT PER \$1,000 OF PER CAPITA PERSONAL INCOME: ARIZONA STATE AND LOCAL GOVERNMENTS AS A PERCENTAGE OF THE NATIONAL AVERAGE



EVALUATION OF K-12 EDUCATION

- The “Quality Counts 2009” study ranks Arizona 41st in the teaching profession category; “Educating Arizona” ranks Arizona 45th on teaching quality.
 - Arizona’s teachers are relatively inexperienced and receive low pay — less relative to the national average than in the past.
- Average classroom size in Arizona is larger than the U.S. average, with Arizona ranking among the bottom few states on this measure and on related measures of the number of pupils per full-time-equivalent teacher and per total educational system personnel.
 - Arizona has fewer administrative staff than the norm.
- Arizona compares more favorably on standards, assessments, and accountability.

K-12 STUDENT ACHIEVEMENT

- Arizona's elementary school students perform near the national average on norm-referenced tests.
- However, all of the other tests administered to elementary and secondary school students indicate that Arizona students perform among the bottom tier of states.
 - On the most recent NAEP tests administered to fourth and eighth graders, Arizona students rank between 37th and 47th.
 - On Advanced Placement tests, Arizona ranks around 40th.
 - “Measuring Up 2008” places Arizona 50th on college entrance exams. While the average score of Arizonans taking the ACT and SAT tests is near average, only a small proportion of high school students in Arizona take the tests.
- Arizona ranks 48th on the percentage of high school freshmen enrolling in college four years later, according to “Measuring Up 2008.”
- Less than half of those who graduate from Arizona high schools are eligible for admission to the state's universities and many of those admitted have deficiencies, according to “Educating Arizona.”
- The preparation for college category of “Measuring Up 2008” ranks Arizona 49th. The K-12 achievement category of “Quality Counts 2009” ranks Arizona 44th.

EVALUATION OF HIGHER EDUCATION

- Participation in higher education at public institutions is quite high in Arizona, particularly at community colleges, with part-time per capita enrollment 59 percent above average.
 - But per capita full-time enrollment is 5 percent below average.
- Several factors contribute to the high enrollment: a higher proportion of those high school graduates from Arizona schools who do go on to college enroll at in-state schools, few private four-year schools are present in Arizona, many of the students enrolled moved to Arizona after completing their K-12 education, many are older than traditional college age, and many are enrolled part time.
- The performance of the higher education system in Arizona is difficult to assess.
 - Arizona ranks a little above the middle of the states on completions according to “Measuring Up 2008.”
 - However, despite the state’s high participation per capita, the number of degrees awarded per capita is slightly below average.

CONSTITUTIONAL REQUIREMENT

- Article 11, Section 10 of the Arizona Constitution reads:
 - “the legislature shall make such appropriations, to be met by taxation, as shall insure the proper maintenance of all state educational institutions, and shall make such special appropriations as shall provide for their development and improvement.”
- Given the unusually large demographic challenges faced by Arizona’s children, the poor performance of Arizona’s elementary and secondary school students even after adjustment for the demographic challenges, the very low public spending relative to other states, and the very significant decrease in spending over time, it is doubtful that the “proper maintenance” clause, much less the “development and improvement” clause, of the Constitution is being met for elementary and secondary education.
- Funding for higher education is considerably below the median state and has decreased significantly over time. In particular, higher education funding from the state general fund has fallen more over time than has general fund expenditures for elementary and secondary education. Thus, funding for higher education also is probably not meeting the constitutional requirement.

PART IV: RECOMMENDATIONS

OUTDATED REVENUE STRUCTURE

- Arizona's revenue system is dated, largely having been put into place decades ago.
- Changes in Arizona's tax system over the last three decades, especially since the early 1990s, have made it less relevant to the contemporary economy and less stable.
 - The state had a reasonably balanced system of tax collections as recently as the early 1990s, with tax revenue coming from multiple broad-based taxes as well as more narrow tax sources.
- State government no longer receives general fund revenue from the vehicle license tax, a stable source over the economic cycle, or from the property tax, usually a fairly stable source of revenue.
- Revenue is insignificant from all taxes other than sales and income. In addition, limited revenue is realized from nontax sources.
- For the most stability in tax revenue, multiple tax sources should be used. In any economic cycle, different sources of tax revenue do not perform equally.

ECONOMIC EFFECTS OF SPENDING REDUCTIONS AND TAX INCREASES

- “Basic economic theory suggests that direct spending reductions will generate more adverse consequences for the economy in the short run than a tax increase” -- Nobel Prize winner Joseph Stiglitz.
- This conclusion was verified for Arizona by two economic forecasting/economic impact estimating models.
- The actual state government spending reduction of \$584.5 million in FY 2009 and spending reductions and/or revenue increases of \$1.6 billion in FY 2010 were modeled.
- The negative economic effects are most severe in the scenario that reduces government spending, and least serious in the scenario that raises public-sector revenue.
- The revenue enhancement scenario assumes a personal tax increase.
 - Currently, personal tax burdens in Arizona are very low compared to other states, while corporate tax burdens do not compare so favorably.
 - Increases in business taxes instead of personal taxes will result in greater negative effects than public spending reductions.

WHY GOVERNMENT SPENDING REDUCTIONS ARE MORE HARMFUL

- “Some of any tax increase would reduce saving rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending on goods and services would directly reduce consumption” – Joseph Stiglitz.
- Government spending reductions severely affect a small number of businesses and state residents (state government employees and workers at businesses that sell to the state). In contrast, a personal tax increase will spread the negative effects throughout the state, with the effect on any individual and on any business being minor.
- A personal tax increase may be deductible from federal taxes and therefore exported to the federal government. A portion also may be exported to tourists and other nonresidents.
- **MYTH: Taxes should not be increased during a recession.** A tax increase is less harmful than public spending cuts, which damage the economy by reducing government purchases from the private sector and by diminishing consumer expenditures made by laid-off government workers. By spreading the negative impact broadly, a tax increase is less likely to have a significantly detrimental effect than spending cuts, which are absorbed by a smaller number of individuals and businesses.

THE EFFECTS FROM GOVERNMENT SPENDING CUTS

- State government is not the only government in Arizona anticipating the need to reduce spending. Many city and county governments already have announced plans to reduce spending in order to balance their budgets.
 - A figure of \$900 million was estimated based on the amount of cuts announced in various cities and counties across the state.
- A projected loss of 51,700 jobs in 2009 from spending reductions by state and local governments in Arizona amounts to 2 percent of Arizona's total wage and salary employment in December 2008.
- While a 2 percent decrease may not seem large at first glance, it is the result of a decline in economic activity in just one sector: government.
- Arizona rarely experienced a decrease in employment in the past.
- Based on the wage and salary employment estimates for December 2008, the decrease in employment was 152,300 since December 2007. Thus, a loss of an additional 51,700 jobs due to government spending reductions during 2009 would substantially worsen and extend the state's economic recession.

HISTORICAL PERSPECTIVES ON FISCAL REFORM

- During the two prior economic recessions, the severity of the state's budget shortfall prompted efforts to study the issue and recommend solutions.
 - In 1989, the Arizona Joint Select Committee on State Revenues and Expenditures ("Fiscal 2000") was formed. Some of its recommendations were adopted, with spending reductions and tax increases resolving the existing structural deficit.
 - A new structural deficit was created by the tax reductions implemented since the early 1990s. In response, the Citizens' Finance Review Commission (CFRC) was formed in 2003. It made a series of recommendations, few of which have been acted upon.
- The need for fiscal reform in Arizona is greater now than it was in 2003.
 - The CFRC's recommendations are as timely today as when they were written.
 - However, the CFRC did not address the issue of the overall amount of revenue to be collected by the state, and thus its recommendations are not adequate to completely resolve the structural deficit.

SHORT-TERM RECOMMENDATION

- Given the very low level of state government general fund expenditures, no further spending reductions beyond those recently put into effect are recommended.
- Instead, the budget deficit could be resolved largely through a combination of federal government stimulus monies and revenue enhancement.
- The most effective way of raising revenue in the near-term is a temporary increase in the transaction privilege (general sales) tax rate.
 - An increase in the sales tax rate also will provide additional funding to local governments due to the distribution of a portion of state government general sales tax revenue to counties and municipalities, most of which also face budget deficits.
- This temporary surcharge in the general sales tax rate is proposed only as a stop-gap measure, to be replaced by an extensive overhaul of the revenue system to be implemented within the next two years.
- In order to offset the higher tax burden that higher sales tax rates place on low-income households, the tax increase should be returned to very low-income taxpayers by increasing the low-income tax credit.

SIZE OF THE IMMEDIATE TAX INCREASE

- Increasing the rate two cents on the current distribution base under current economic conditions would generate approximately \$1.6 billion for the state general fund and an additional \$425 million to be distributed to counties and municipalities per year.
- A tax increase of \$1.6 billion equates to less than \$250 per Arizona resident, or less than \$675 per household.
 - The actual tax increase on individuals would be less, given that businesses and visitors to the state would pay a portion of the \$1.6 billion.
- Even assuming that no other state raises taxes, Arizona still would rank as a low-tax state at 34th, based on Tax Foundation data.
- A tax increase of this magnitude would offset only a portion of the state tax cuts implemented between 1993 and 2008.
- This tax increase would be smaller in magnitude than the federal income tax rebate distributed in 2008 and the federal income tax reduction of 2009.

LONG-TERM PRINCIPLES

- Permanent changes in the revenue system need to close the structural budget deficit, cause the revenue stream to be less cyclical, and result in revenue growing at the pace of the overall economy.
- The ideal revenue system will have a very broad and varied tax base, but apply low tax rates.
- It will better balance business taxes with personal taxes — currently, business taxes are high relative to personal taxes.
 - More broadly, it should promote a business climate conducive to the growth of basic economic activities.
- Other aspects of an improved system will be to ensure a progressive tax structure — either explicitly or through the use of low-income tax credits.
 - In general, however, tax credits and tax exemptions should be minimized.
- More generally, the guiding principles adopted by the CFRC should be widely applied in creating a new revenue system.

LONG-TERM RECOMMENDATIONS: REVENUE ENHANCEMENTS AND SPENDING OBLIGATIONS

- A key recommended change in the revenue system is to reinstitute the state property tax, but to lower property taxes on businesses.
- Another is to broaden the general sales tax base by including some services and eliminating some exemptions, but to reduce the general sales tax rate.
- Other suggestions include expanding the use of debt financing for capital outlays, eliminating tax credits, and raising revenue from nontax sources.

SUMMARY OF REVENUE ENHANCEMENTS/REMOVAL OF SPENDING OBLIGATIONS: ARIZONA STATE GOVERNMENT GENERAL FUND

	Possible Net Effect
1. State property tax	\$500 million
2. Debt financing	>\$300 million in selected years
3. General sales tax	>\$500 million
4. Tax credits	>\$100 million
5. User fees	Uncertain, but <\$375 million
6. Vehicle license tax	\$200 million
7. Money management	Uncertain
8. Federal funding	Uncertain
9. Selective sales tax	<\$100 million, little to general fund
10. Personal income tax	<\$100 million in "fairness" tax

LONG-TERM RECOMMENDATIONS: REGULATING REVENUES & EXPENDITURES

- With a modernized tax code that employs a broad tax base, supplemented by expanded nontax sources of revenue and improved planning and money management, policymakers could be assured of general fund revenue that averages a particular percentage of the state's GDP and that does not vary too widely in any year from the target percentage.
- If controls also were placed on spending, then the size of cyclical budget deficits would be minimized and the rainy-day fund cap could remain at 7 percent.
- Revenue enhancements should be adopted such that general fund revenue is equal to 4-to-4.5 percent of Gross State Product.
 - Establishing a tax base that grows with — neither faster nor slower than — the pace of the Arizona economy is the essential ingredient to re-establishing fiscal order.
- Spending increases should be controlled to the sum of population growth, inflation, and real per capita economic growth.

LONG-TERM RECOMMENDATIONS: BUDGET STABILIZATION FUND

- If the recommendations to target general fund revenue at a constant share of Arizona's economy and to tie spending increases to a formula are not adopted, then improving the operation of the rainy-day fund will be necessary to avoid large budget deficits during economic downturns.
- The specific recommendations are to
 - Return the budget stabilization fund cap to 15 percent, or higher.
 - Safeguard the operation of the budget stabilization fund.
 - Seed the budget stabilization fund with additional deposits.
 - Create additional contingency funds.
 - Minimize permanent tax reductions or spending increases.
- Any future permanent tax reduction should be accompanied by a permanent reduction in spending, and any future spending increase should be accompanied by a permanent increase in revenue. In years in which a surplus remains even after standard and supplemental transfers to the rainy-day fund and other contingency funds, the excess funds should be used for a rebate to taxpayers or for one-time spending.