

**PUBLIC FINANCE IN ARIZONA
VOLUME III: OPTIONS FOR MANAGING THE ARIZONA
STATE GOVERNMENT GENERAL FUND**

A Report from the Office of the University Economist

December 2008

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PREFACE

This is the third of a series of three reports that discuss government finance in Arizona. The reports are available at www.wpcarey.asu.edu/seid/ccpr.

An objective review of government finance in Arizona is presented in the first volume. Included in the report are analyses of Arizona state government finance, using data of the Arizona Joint Legislative Budget Committee, and of the combined finances of all state and local governments within Arizona, using data of the U.S. Census Bureau. A historical perspective is provided for both datasets. For combined state and local government finance, comparisons are made to other states and to the national average. In addition, other measures of the tax burden by state are examined.

The second volume goes beyond the factual material included in the first volume. It particularly addresses the conceptual and empirical relationships between taxes, government revenue, and economic growth. It also discusses current issues specific to Arizona state government finance. The second volume is a revised version of the report “Tax Reductions, the Economy, and the Deficit in the Arizona State Government General Fund,” incorporating new and updated material.

This third volume presents options and offers recommendations for managing the Arizona state government general fund. The near-term budget deficit is addressed as well as ways to prevent budget deficits from recurring every time economic growth slows. The third volume is an update to the report “Options for Managing the Arizona State Government General Fund: Closing the Structural Deficit and Preventing Large Deficits in the Future,” but few changes were made.

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SUMMARY

More than five years ago, the need for state government fiscal reform was recognized. Governor Napolitano formed the Citizens' Finance Review Commission (CFRC), which focused on the state government revenue system. Without addressing the issue of the overall amount of revenue to be collected by the state, the Commission five years ago 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. In this report, a number of recommendations — mostly matching the CFRC's recommendations — are made. However, this report goes further than did the CFRC by addressing the structural deficit between state government general fund revenue and expenditures.

Following a significant budget deficit in the state general fund in the last fiscal year, another large deficit needs to be closed in the current fiscal year, and an even larger deficit is projected for the next fiscal year. With most of the "easy" budget fixes already in use, balancing the budget in the current and succeeding years will be much more challenging. With little time remaining before the end of the fiscal year on June 30, only a few of the revenue enhancements discussed in this paper will be available to solve the current year's budget dilemma. The current deficit will likely need to be closed primarily through spending reductions.

These spending cuts will have real and significant impacts on the Arizona economy, on state government employees, and on disadvantaged citizens relying on public assistance. Underlying this statement is the recognition that, unlike the private sector, most demands on the public sector do not decline during a recession, and some increase.

The problem, however, is much deeper than a short-term imbalance between revenue and expenditures. Due to a sizable structural deficit, the state faces the prospect of needing to make difficult decisions to balance the budget every time economic growth slows. Thus, while the current dilemma was a prompt for the development of this paper, the main focus is to resolve the long-term imbalance and to suggest other fiscal improvements.

The structural deficit in part is the result of an outdated tax code that creates large cyclical swings in revenue and that causes revenue to grow more slowly than the pace of the overall economy. Much of the structural deficit, however, results from numerous and substantial tax reductions passed by the Arizona Legislature over the last 15 years that were not matched by spending reductions of a commensurate size. Given the increasing population-driven demands for public services and infrastructure, such as health care, education, and public safety, and the amount of the state government general fund expenditures that are off limits to spending reductions due to voter initiatives or statutory mandates, it will not be possible to resolve the budget deficit in the current and following fiscal years by spending reductions alone — at least not without decimating entire programs.

State government general fund revenue relative to the size of the Arizona economy has fallen significantly since 1995 and currently is at a historical low. Expenditures, too, have declined since 1995 relative to measures of the size of the Arizona economy. From any historical

perspective it is clear that spending increases beyond the needs of a growing state did *not* cause the current cyclical deficit or the long-term structural deficit.

Other actions also have contributed to the near-term dilemma. For example, the Legislature weakened the provisions of the original legislation setting up the budget stabilization fund. The result is less monies available for transfer from the rainy-day fund to the general fund during a recession and a greater need for spending reductions or revenue enhancements to balance the budget.

Immediate action needs to be taken to resolve the budget imbalance in the current fiscal year. In addition to inevitable spending cuts, immediate action is needed to enhance revenue. The most effective way of doing this in the near-term is an increase in the transaction privilege (general sales) tax rate. Though not recommended as a long-term strategy, an immediate increase in the state sales tax rate is the most effective way to quickly increase revenue. The rate increase will need to be significant. The sooner it is implemented, the greater will be the benefit in the current fiscal year.

This temporary surcharge in the general sales tax rate is proposed only as a stop-gap measure, to be replaced by permanent changes in the revenue system, implemented within the next two years. A temporary 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, many of which also face budget deficits.

Policymakers need to confront the severity of the current budget crisis that has deepened significantly since September. If revenue is not enhanced immediately, funding for public programs in Arizona will be so low that basic state government functions will be compromised. In the longer term, the state will not be able to keep pace with the demands of a growing population, resulting in deterioration in the state's infrastructure and in the quality of life of its residents.

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 economic growth. 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.

Key recommended changes in the revenue system include reinstating the state property tax and broadening the general sales tax base by including some services and eliminating some exemptions, while reducing 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.

Such reforms to the revenue system will not be adequate to create a well-functioning fiscal system. In addition, either of two alternatives should be implemented:

1. In addition to creating a revenue system that eliminates the structural deficit, grows with the economy and is not too cyclical, the preferred alternative anchors general fund revenue at a certain percentage of the state's economy, such as 4 or 4.5 percent of Arizona gross domestic product. Further, expenditures will be limited to a formula that consists of the sum of population growth, inflation, and real per person economic growth. Core expenditure needs could be met by spending growth at the pace of inflation and population. The real per person economic growth portion (which averages 2 percent per year) will provide for productivity-enhancing investments and other needs. Once in place, these fiscal guidelines will ensure that spending and revenue capacity will grow at the overall pace of the Arizona economy, meeting requisite public-sector needs and avoiding the catastrophic structural imbalances that exist today.

2. The second alternative is less ambitious in that it suggests fewer changes to the status quo. In addition to creating a revenue system that eliminates the structural deficit, grows with the economy and is not too cyclical, it strengthens the budget stabilization fund so that more monies will be available to transfer into the general fund at times of economic weakness.

THE ARIZONA STATE GOVERNMENT GENERAL FUND

In Volume I of *Public Finance in Arizona*, the Arizona state government general fund — revenue and expenditures was examined in some detail. To control for inflation, population growth, and real per capita economic gains, revenue and expenditures were presented per \$1,000 of personal income. While personal income is most often used to standardize public finance data over time, this is not the only measure that might be used.

In this section, two other measures are used to adjust the revenue and expenditure data: gross domestic product (GDP) for the state and aggregate adjusted gross income (AGI — of Arizona residents plus the Arizona share of nonresident incomes). Adjusted gross income — the top line on the Arizona tax return — presents an alternative that is particularly appropriate for the determination of tax burdens. Since GDP is the broadest measure of the size of an economy, it is the measure used in a proposal of a new way to budget government revenue and expenditures, on page 16.

An Examination of General Fund Revenue and Expenditures

A simple comparison of Arizona state government general fund revenue to the size of the Arizona economy reveals that revenue is decreasing as a percentage of the overall economy. Most recently, there is an absolute decrease in revenue while the economy generally continues to grow, albeit slowly, in unadjusted (nominal) dollars.

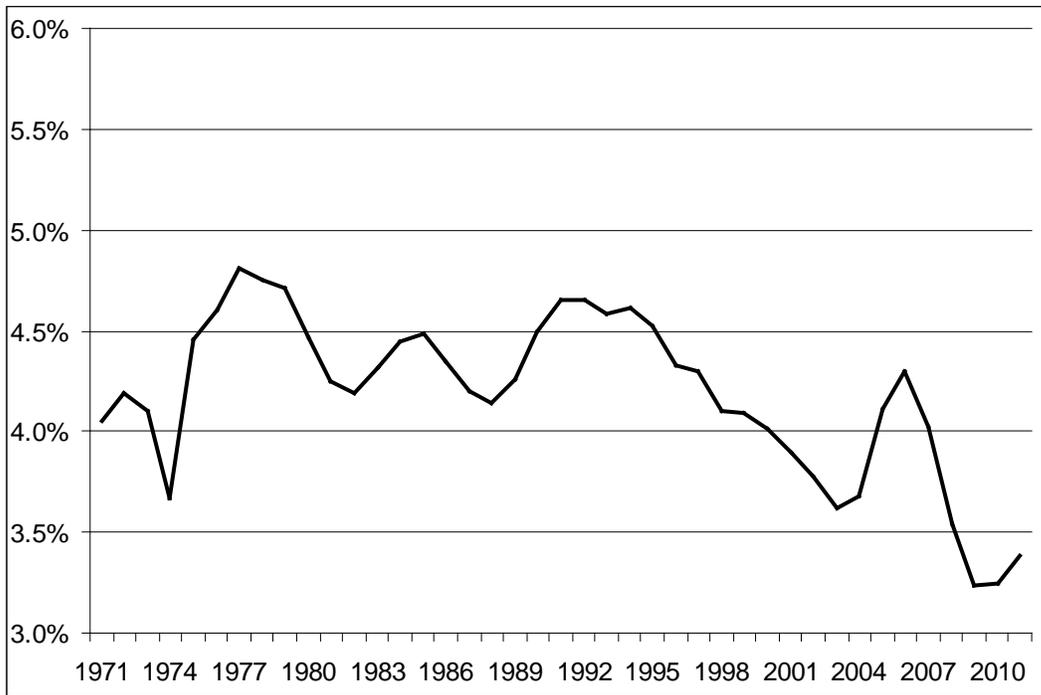
Chart 1 displays state general fund revenue as a proportion of the state's gross domestic product. A very large decline since the mid-1990s is obvious, though considerable cyclicity is present. In Chart 2, revenue is shown per \$1,000 of personal income and per \$1,000 of adjusted gross income. These measures also show a decline in revenue since the mid-1990s. Generally, each of the three revenue measures declines during economic slowdowns and rises during expansions.

In each measure, fiscal year revenue is compared with the prior calendar year's economic activity. This is necessary since the GDP and AGI measures are available only annually. To be consistent with these two measures, calendar year PI also is used, making the revenue and expenditure figures per \$1,000 of personal income different from those in Volume I, which was based on fiscal year PI.¹

The revenue figure used is “ongoing revenue” as reported by the Arizona Joint Legislative Budget Committee (JLBC), which excludes any carry-forward amount from the prior year.

¹ The economic variables could be converted to fiscal years without altering the basic conclusions of this exercise. However, the size of the economy in the calendar year that spans the first half of each fiscal year has an important influence on both revenue collections and spending needs. Moreover, the representations in the chart would not be affected by inflation-adjusting the fiscal and economic variables since each graph represents a ratio of fiscal variables to economic variables.

CHART 1
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE AS A SHARE OF
ARIZONA GROSS DOMESTIC PRODUCT, 1971 THROUGH 2011



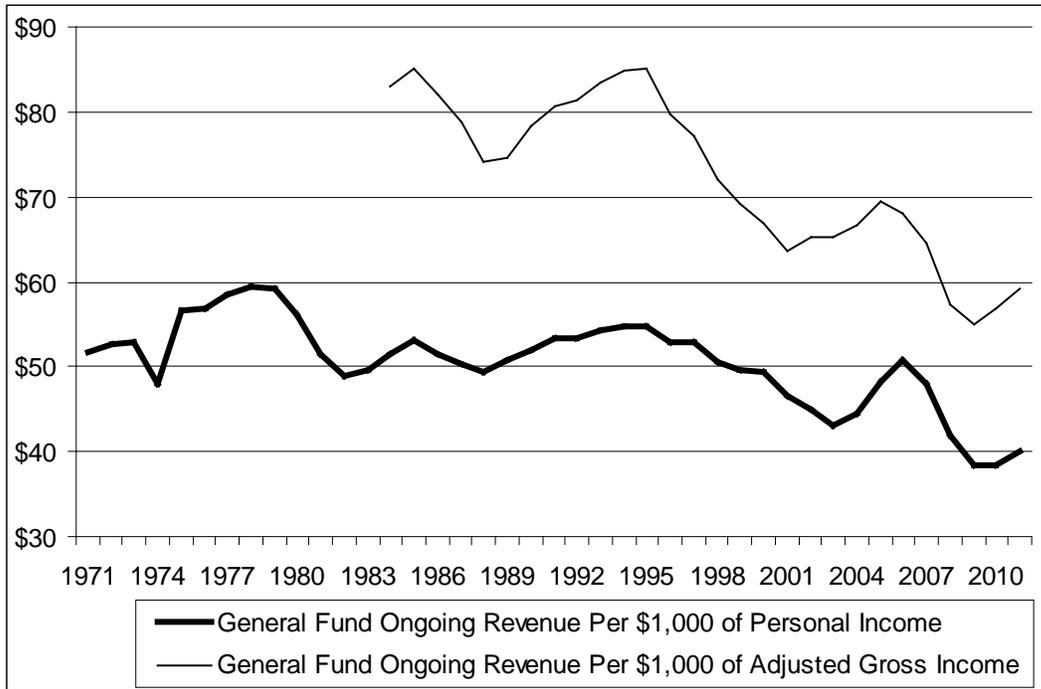
Sources: Arizona Joint Legislative Budget Committee (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis (gross domestic product).

Each measure has been projected through fiscal year (FY) 2011.² The most recent actual GDP and PI data are for calendar year 2007. The latest tax data are for 2006. The JLBC actual revenue data run through FY 2008.

From fiscal years 1975 through 1995, state general fund revenues averaged 4.5 percent of Arizona GDP. The share fell below 4 percent during and after the last economic downturn (fiscal years 2001 through 2004) and is headed down again currently, projected to fall as low as 3.25 percent. Expressed per \$1,000 of personal income, the decline since FY 1995 is from about \$55 (the average from fiscal years 1975 through 1995 was close to \$54) to less than \$40. Using data from the tax rolls, which include capital gains income, the decline in revenue per \$1,000 of AGI is from a peak of about \$85 in FY 1995 (and an average of \$81 from FY 1984 — the first year of data — through FY 1995) to under \$60.

² Revenue forecasts through 2011 are simulations based on the current state of the economy as of October 2008. These forecasts call for very slow growth, and even declines, in major revenue categories in 2009, slightly faster growth in 2010, and more robust growth in 2011. Revenue dampening factors related to problems in the housing market, a lack of consumer confidence, and dwindling prospects for capital gains collections continue, while no apparent catalysts that will generate significant revenue growth can be cited.

CHART 2
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE RELATIVE TO
ARIZONA PERSONAL INCOME AND ADJUSTED GROSS INCOME,
1971 THROUGH 2011



Sources: Arizona Joint Legislative Budget Committee (revenue), U.S. Department of Commerce, Bureau of Economic Analysis (gross domestic product), and Arizona Department of Revenue (taxable income).

Several possible explanations can be forwarded for the relative decline in each of the three revenue measures since the mid-1990s. Some argue that spending outside the general fund for obligations historically associated with the state general fund allow revenue ratios to decline. The primary example is the revenue from the 0.6 percent increase in the general sales tax that was passed by voters in 2000 to earmark funds for education, referred to as “proposition 301.” This argument is correct to a degree, but ignores other statutory acts that eroded the monies available for traditional general fund expenditures. Students FIRST, which transferred a considerable portion of the school construction obligation to current general fund resources, and the large number of tax credits and exemptions that have been enacted in recent years are examples. These actions more than offset the 0.6 percent sales tax that funds proposition 301.

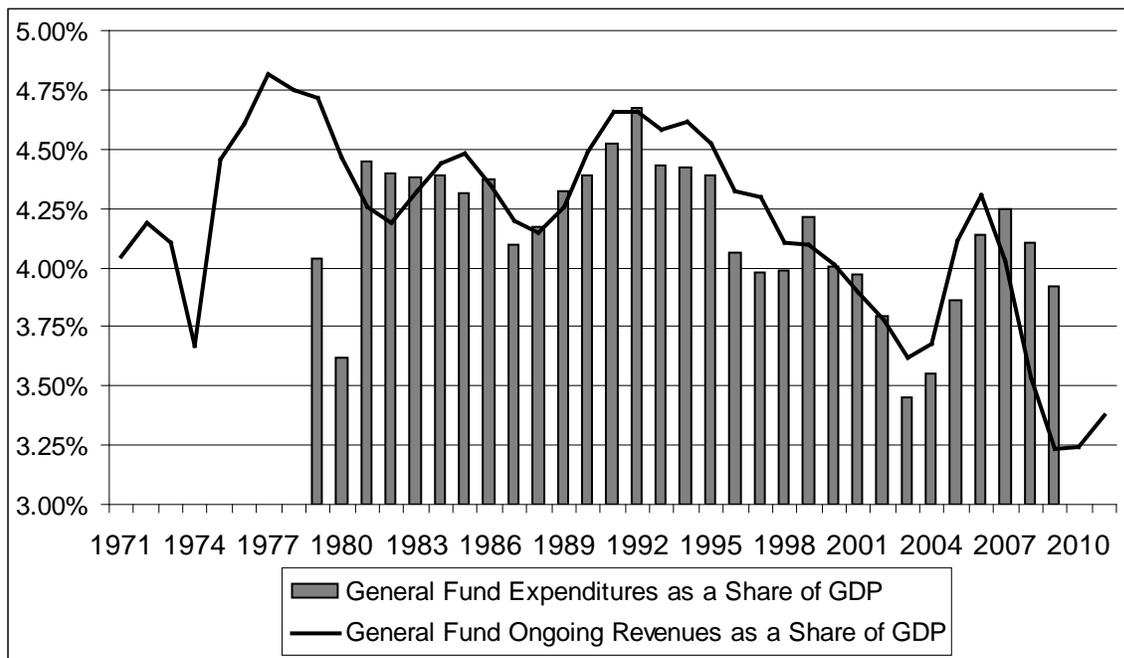
The most important factor contributing to the decline in state general fund revenue relative to the size of the Arizona economy is the substantial tax rate reductions that have been implemented since the early 1990s. Permanent reductions in tax rates or the elimination of tax bases for the general fund have resulted in a reduction in available revenue that accumulate to approximately 1.2 percent of GDP or about \$3 billion per year.

These figures are consistent with the tax burden data generated by the Tax Foundation. The tax burden is calculated as total state and local government taxes paid per capita as a share of per capita income. In 1993, Arizona ranked 29th among the states, with a tax burden about 5 percent below the national average. In 2008, Arizona's rank is 41st, with a burden more than 12 percent below the national average. Taxes as a share of income fell in Arizona over the 15 years from 9.7 percent to 8.5 percent.

The tax cuts, coupled with cyclical factors — substantial declines in consumer confidence, dwindling prospects for stable capital gains income flows, and a corporate tax base that is showing significant signs of deterioration — have resulted in a general fund tax base that currently is at historic lows as a share of the Arizona economy.

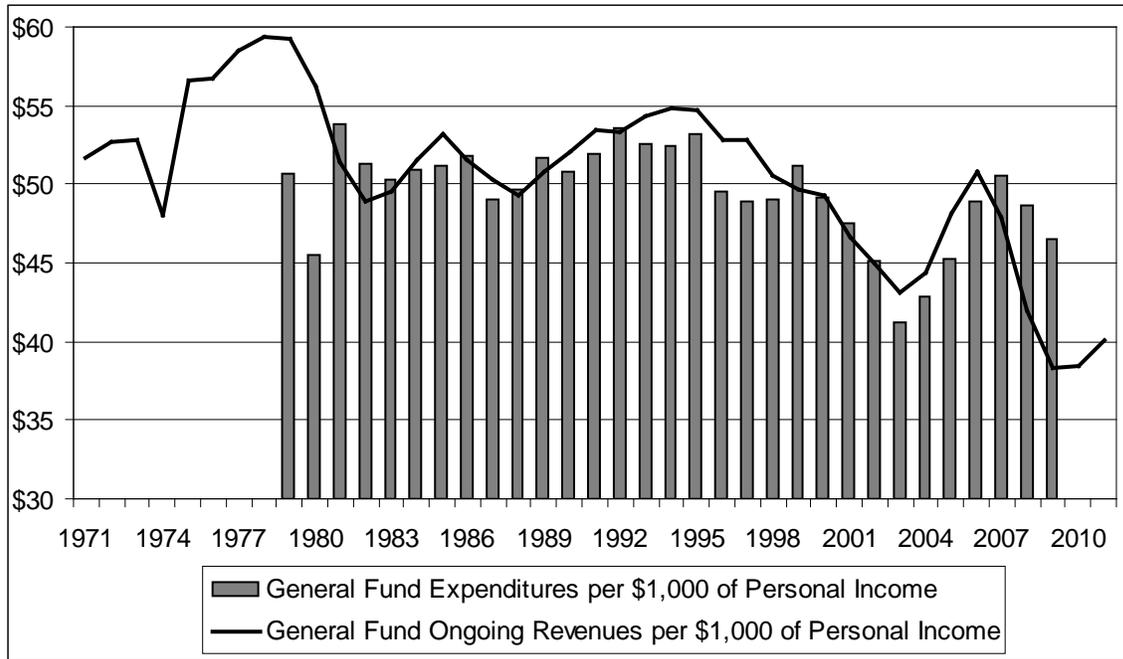
Charts 3 through 5 compare revenue with expenditures, expressed relative to each of the three measures of the Arizona economy. The charts reveal that expenditures also are declining as a share of the Arizona economy. Spending in FY 2007 and FY 2008 was financed by the budget surpluses in fiscal years 2003 through 2006. In the current fiscal year (2009) — the last expenditure figure (bar) in each graph — appropriated expenditures are presented. It is unlikely that the state will be able to spend the budgeted amount due to the decline in ongoing revenues. When actual data for FY 2009 are compiled, the last bar in each chart will be much closer to the ongoing revenue line.

**CHART 3
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE AND
EXPENDITURES AS A SHARE OF ARIZONA GROSS DOMESTIC PRODUCT,
1971 THROUGH 2011**



Sources: Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross domestic product).

CHART 4
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE AND
EXPENDITURES RELATIVE TO ARIZONA PERSONAL INCOME,
1971 THROUGH 2011



Sources: Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income)

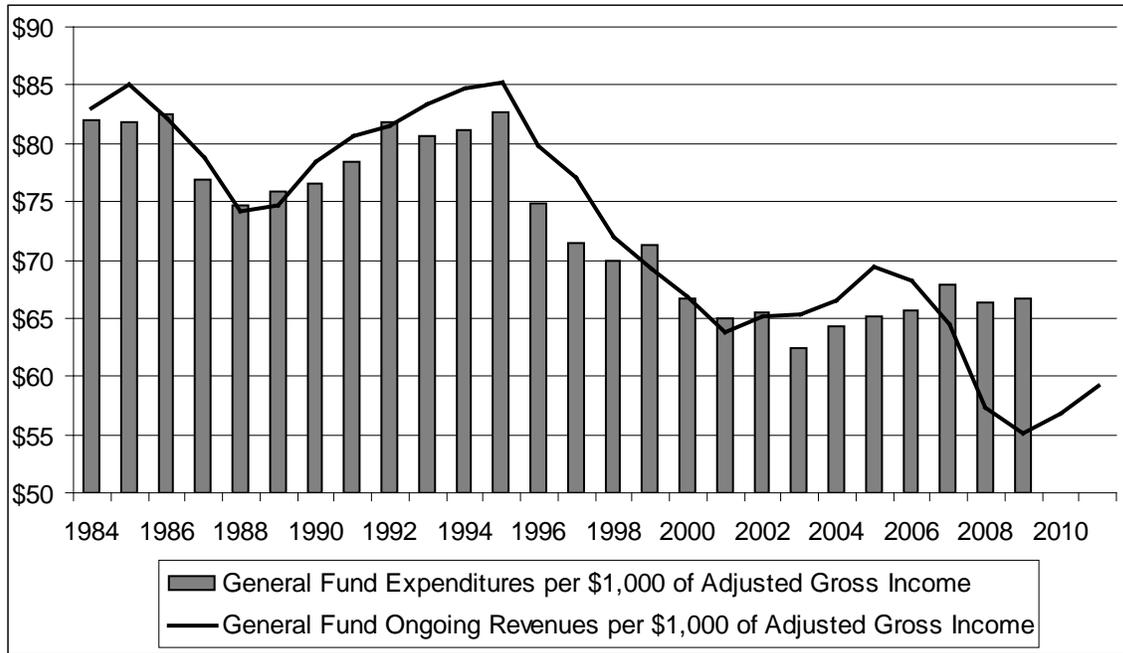
These charts illustrate that spending as a share of each economic measure rose from FY 2003 through FY 2007 from a historically very low amount, but that expenditures at the peak in FY 2007 remained below historical cyclical peaks. The acceleration in spending as a share of adjusted gross incomes (Chart 5) was very small in comparison with historical levels since capital gains boosted growth in adjusted gross incomes from 2003 to 2007 to rates significantly faster than growth in GDP or personal income.

Simulated Revenue and Expenditures

In this subsection, actual general fund revenue and expenditures are compared to what they would have been had they increased at the rate of the economy. In Charts 6 and 7, the bars present actual general fund ongoing revenue and expenditures from FY 1985 to the present, with projections thereafter. The lines in the graph represent a simulated revenue and expenditure trajectory that would have allowed revenue and expenditures to grow at the same rate as the overall economy as measured by the growth of nominal GDP.³ The choice of 1985 to begin the chart is arbitrary, but going back this far reveals the actual revenue and

³ The exercise could have been conducted using real GDP and real revenues and expenditures without altering any conclusions. Replacing nominal GDP with nominal personal income in the exercise yields exactly the same conclusions. Simulated revenue and expenditures differ with the use of PI growth by less than \$50 million dollars.

CHART 5
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE AND
EXPENDITURES RELATIVE TO ARIZONA ADJUSTED GROSS INCOME,
1984 THROUGH 2011



Sources: Arizona Joint Legislative Budget Committee (revenue and expenditures) and Arizona Department of Revenue (adjusted gross income).

expenditure patterns through two full recessions and the beginning of the current recession. In the current fiscal year (2009), ongoing revenue is falling far short of planned expenditures.⁴

The projected pattern of revenue collections through 2015 is illustrative, based on current trends with spending aligned with ongoing revenue beginning in 2010.⁵ The charts reveal that after FY 1995, revenue and expenditure growth began to lag growth in GDP. Since FY 1995, in no year has actual revenue attained the trend line based on revenue at GDP growth. Actual expenditures exceeded the growth trend once, by \$90 million in FY 2007.

In Chart 8, actual and projected expenditures through 2015 minus revenue simulated at the GDP growth trend line are displayed (the actual expenditures from Chart 7 less the simulated revenue from Chart 6). The graph reveals that actual expenditures exceeded simulated revenue only in the early 1990s. The departure of actual expenditures from simulated revenue grows rapidly following FY 1995.

⁴ The 2009 deficit is NOT revealed by these graphs since the state has access to some “one-time” monies. The expenditure patterns from 2010 and after assume all “one-time” options are exhausted.

⁵ Assumptions for nominal GDP growth are 3 percent for calendar years 2008 and 2009, 5 percent for 2010, 6 percent for 2011 and 7 percent thereafter. Revenue growth is -5.8 percent for fiscal year 2009, 3.3 percent for FY 2010, 9.4 percent for FY 2011 and matches GDP growth at 7 percent thereafter.

CHART 6
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE:
ACTUAL/PROJECTED COMPARED TO SIMULATED, 1985 THROUGH 2015

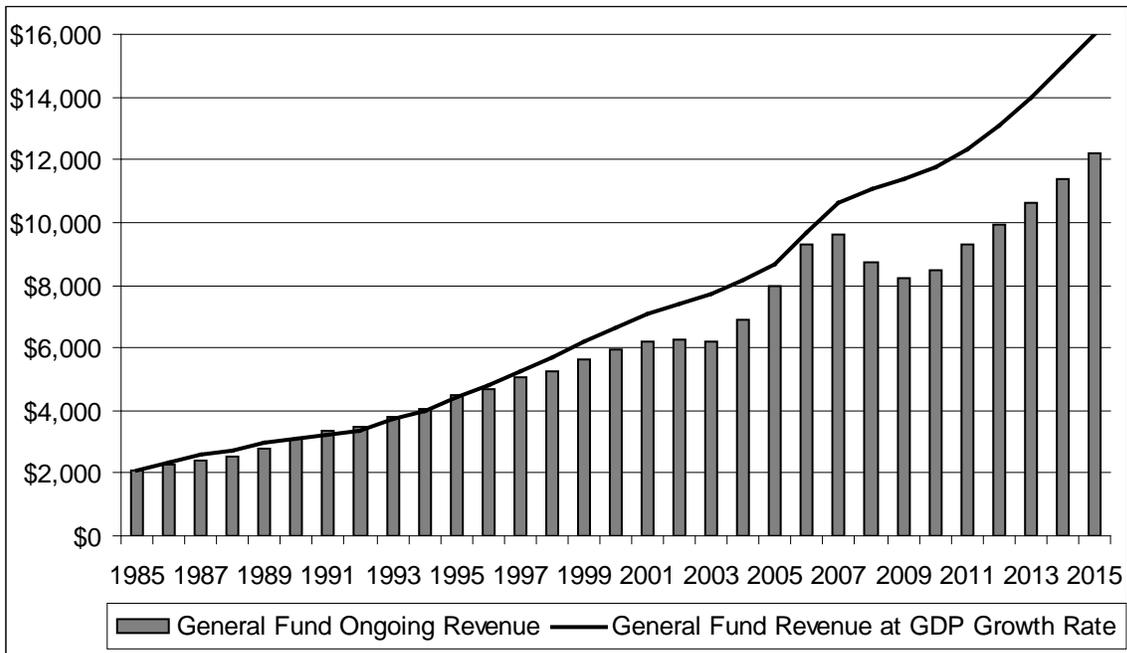
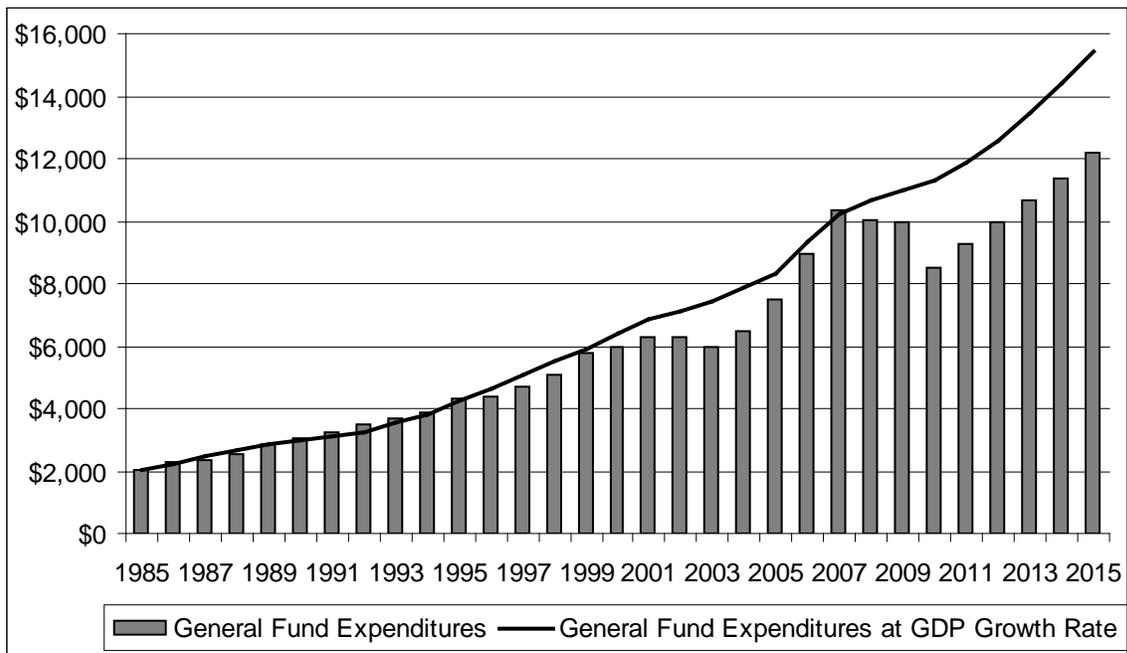


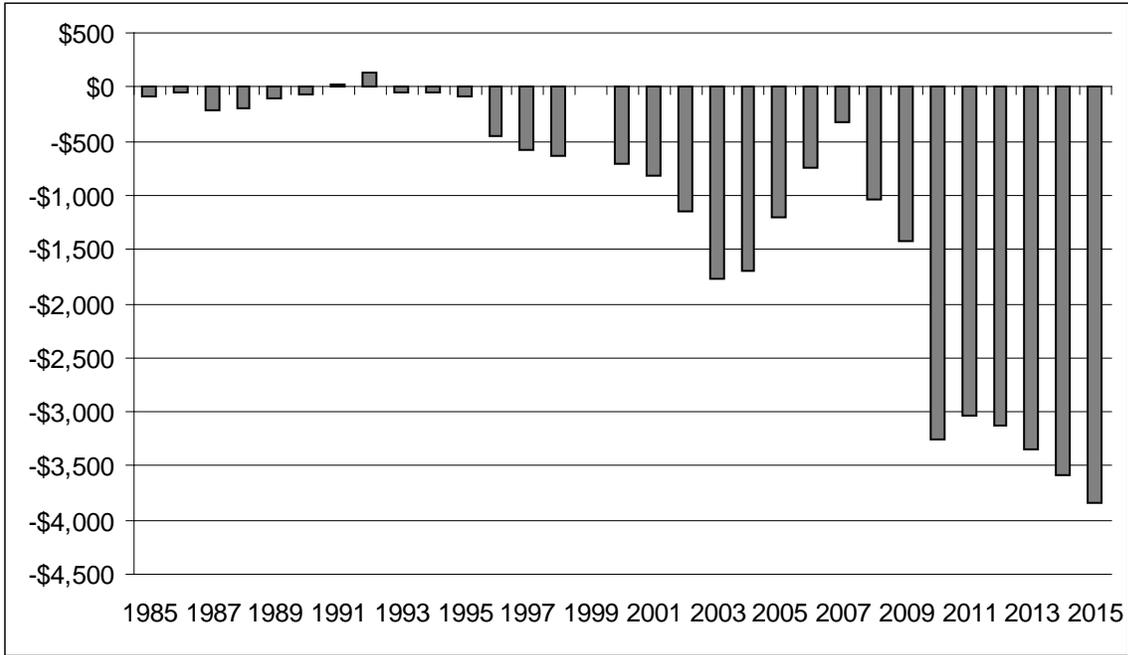
CHART 7
ARIZONA STATE GOVERNMENT GENERAL FUND EXPENDITURES:
ACTUAL/PROJECTED COMPARED TO SIMULATED, 1985 THROUGH 2015



Note: dollars in millions.

Sources (Charts 6 and 7): Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

CHART 8
ARIZONA STATE GOVERNMENT ACTUAL/PROJECTED GENERAL FUND
EXPENDITURES LESS SIMULATED REVENUE, 1985 THROUGH 2015
(Dollars in Millions)



Sources: Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

OPTIONS TO IMPROVE THE MANAGEMENT OF THE STATE GENERAL FUND

While any number of options regarding the management of the state general fund are possible going forward, most are not recommended. Four options are discussed below, with the two alternative recommendations examined in more detail in the following subsections.

1. **Status quo:** not recommended. Without any changes to the management of the general fund, severe spending reductions will need to be made to balance the budget during the current fiscal year. Additional reductions likely will be necessary in the next fiscal year. While such spending cuts would reduce or eliminate the structural deficit, such substantial reductions in the short term will worsen and prolong the current recession in the Arizona economy, and will cause hardships for those workers who lose their jobs as well as for disadvantaged individuals dependent on government assistance, as discussed in Volume II of *Public Finance in Arizona*. More generally, the state would be unable to meet its basic obligations at such a low level of expenditures.

If spending were increased when the economy recovers and general fund revenue rises, another structural deficit would be created, requiring further budget cuts the next time the economy slowed. Such up-and-down spending is totally inappropriate since public needs do not vary much with the economic cycle, and certainly do not decrease during economic slowdowns.

If spending were not increased when the economy recovers, ongoing expenditures would be far below historical levels and would impede the state's ability to perform crucial public services. It would be impossible to catch up to, and then keep up with, the infrastructure needs of a growing population.

2. **Status quo, but with improvements to the budget stabilization fund:** not recommended, though preferable to the first option. If more monies were transferred to the rainy-day fund (see the following subsection) during the next economic expansion, the size of the needed budget cuts in the next economic downturn would be lessened and state government spending would be less cyclical. However, all of the other negative repercussions of the first option would remain.

3. **Status quo, with improvements to the budget stabilization fund, and with changes to the tax base that enhance revenue — eliminating the structural deficit — and provide for a more stable revenue stream that grows with the economy:** recommended, though not as highly as the fourth option. The two key provisions of this option are better use of the rainy-day fund and closing the structural deficit through revenue enhancement. The revenue enhancement also would result in tax revenue being less cyclical and growing with the economy. This option provides an acceptable, though not optimal, way to manage the state general fund and is discussed in the following subsection.

4. **Adopting a new way of budgeting revenue and expenditures, and making changes to the tax base to enhance revenue — eliminating the structural deficit — and provide for a more stable revenue stream that grows with the economy:** recommended. This option is the optimal way to manage the state general fund. Its unique provision is that growth in state government spending will be controlled to increases in economic growth. The other key provision is the same as in the third option — revenue enhancement to eliminate the structural deficit and to modernize the tax code so that revenue expands with economic growth — but with one addition: targeting

revenue to be a certain share of the state economy. The result will be much smaller budget surpluses and deficits across an economic cycle. This option is discussed beginning on page 16.

Option 3: Improving the Status Quo

This option consists of two major changes. First, the structural deficit is closed, and in the process of doing so, the revenue mix is changed to be less cyclical and to grow with the economy. A number of alternatives to accomplish this task are discussed beginning on page 22. Second, operation of the rainy-day fund is improved and the addition of other contingency funds is considered.

The actual operation of the budget stabilization fund (BSF), also known as the “rainy-day fund,” was discussed in Volume I. In general, the BSF is designed to set aside revenue during times of strong economic growth to be spent during periods of weak growth or recession. As noted in Volume II, the funding of the BSF in the two economic cycles of its existence has been substantially inadequate to meet the revenue shortfalls that have occurred in each of the economic recessions.

Simulations of the operation of the BSF reveal two primary weaknesses in the current BSF statute: (1) capping the BSF at 7 percent of the general fund provides a substantially inadequate amount of monies to transfer to the general fund during a typical economic downturn, and (2) even if the cap is returned to 15 percent, as in the original legislation, the fund will not achieve such a balance based on the formula-dictated transfer to the fund during years of strong economic growth. This is particularly true if the fund balance during the prior economic recession dropped to zero or only a few percent of the general fund.

However, even if the BSF attains a 15 percent balance during each economic expansion, revenue-expenditure imbalances could still occur during economic downturns:

- Demand on the public sector increases during downturns — the opposite of reductions in demand that occur through much of the private sector. Thus, the need to expend public monies rises at a time when general fund revenue is falling (or held constant by BSF transfers).
- Legislative decisions during periods of strong economic growth to increase expenditures without creating a new funding source and/or to reduce taxes without adopting associated spending cuts will create a structural deficit that does not become apparent until economic growth slows.
- Changes in the revenue mix implemented since the early 1990s have increased the volatility and decreased the responsiveness of the revenue stream.
- A severe economic downturn could cause revenue to drop so much that a transfer of more than 15 percent from the BSF would be required to balance the budget.

The Citizens’ Finance Review Commission (CFRC) in 2003 made the following recommendation regarding the BSF: “The state should increase the current limit on the budget stabilization fund (the ‘rainy day fund’) to its original 15-percent cap and take measures to make ‘raids’ on the fund more difficult.” Alberta Charney of the University of Arizona argued for a cap of at least 30 percent.

The operation of the budget stabilization fund can be viewed as a budgeting procedure not needing legislative oversight. Further, over the last 15 years, the Legislature has reduced the effectiveness of the BSF through statutory changes, used the fund for other purposes, and made ad hoc rather than the formula-recommended transfers to and from the fund. These issues could be resolved by specifying the operation of the BSF in the state constitution rather than in statute. Constitutional provisions that transfers to and from the fund be made automatically without legislative action and that the BSF be allowed to attain at least 15 percent of general fund revenue would ensure the effectiveness of the BSF.

Following an economic recession during which the BSF balance drops to a few percent or less of general fund revenues, the BSF will not be able to attain at least a 15 percent balance during the next economic expansion if transfers to the fund are limited to those specified in the formula included in the 1990 legislation. In such situations, the BSF needs to be “seeded” with supplemental transfers from the general fund during the next economic expansion when budget surpluses exist even after the formula-recommended transfer to the BSF. This, too, should be specified by formula and transfers should be made automatically.

In addition to cyclical swings in revenue that can be resolved by a properly designed BSF, the state also experiences fluctuations in expenditures. Some of this variability is not easily predicted: judicial decisions sometimes order the state to expend funds, and some programs (such as alternative fuels) experience unexpected expenses. This suggests that a contingency fund under the discretion of the Legislature be created. Monies could be transferred to the contingency fund during periods of strong economic growth when a surplus remains even after the formula-specified transfer to the BSF and any additional seeding of the fund is required. Some expenditure fluctuations are predictable. The loss of jobs and income that occurs during recessions — which are inevitable — results in increased demands on health and welfare programs such as AHCCCS during each downturn. An additional contingency fund could be used to smooth out these cyclical fluctuations in expenditures. Alternatively, this function could be added to the design of the BSF. If so, the size of transfers to and from the BSF would need to be increased and the cap would need to be raised beyond 15 percent.

In years in which surpluses remain even after standard and supplemental transfers to the rainy-day fund and other contingency funds, two options exist: a rebate to taxpayers or one-time spending. The existence of a surplus should never prompt a permanent tax cut or spending increase. Any future permanent tax reductions should be accompanied by a permanent reduction in spending and any future spending increase should be accompanied by a permanent increase in revenue.

Option 4: Adopting a New Way of Budgeting Revenue and Expenditures

There is considerable discussion today about the size of government, the pace of government expenditures in recent years, and whether policymakers should make massive cuts in spending or raise taxes to resolve the current budget shortfall. The unenviable position that the state finds itself in today is partly due to the significant slowing in the nominal growth of the Arizona economy (the economic recession), but it is also the inevitable consequence of a policy of continual tax rate reductions.

In option 3, even if the structural deficit in the general fund is closed, the need exists to bolster the rainy-day fund to prevent large budget deficits from occurring in the future at times of economic decline. However, another alternative exists that would minimize the size of cyclical budget deficits and allow the rainy-day fund cap to remain at 5 percent. That alternative is to maintain general fund revenue at a nearly consistent share of Arizona's gross domestic product and to tie spending increases to a formula. 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.

In this subsection, the results of a budget simulation undertaken to compare the revenue and expenditures based on reasonable rules for the progression of each are presented. As illustrated earlier, prior to FY 1995, general fund revenue frequently (14 times from 1971 to 1995) exceeded 4.5 percent of GDP and was above 4.5 percent in each of the five years leading up to FY 1995. For purposes of this simulation, it is assumed that Arizona has a tax code that yields revenue deposits in the general fund that are 4.5 percent of the GDP in the prior calendar year.

Next, it is assumed that spending from the general fund grows roughly at the pace of the overall economy, as measured by GDP or a similar economic measure. One way to think about this is to recognize that a spending rule might be comprised of the sum of population growth, inflation, and the average per capita real growth of the economy (about 2 percent per year). The tax burden as a share of the economy would be stable in this situation. A spending rule of population growth plus inflation plus 2 percent would allow spending to grow at about the pace of the overall economy, approximately 7 percent per year over the last 20 to 25 years in nominal terms. Core expenditure needs could be met by spending growth at the pace of inflation and population. The real per person economic growth portion will allow for productivity-enhancing investments to be made and for other needs (for example, expanded spending for research, education, infrastructure, or in response to new mandates) to be met. Charts 9 and 10 present the results of this simulation: spending growing at the sum of population growth, inflation, and the average per capita real growth of the economy, financed by a revenue base that in each fiscal year approximates 4.5 percent of state GDP.⁶

This simulation could be based on aggregate personal income or other measures of the aggregate growth in the Arizona economy rather than GDP. The essentials are to create a revenue stream that comes close to being a constant share of the Arizona economy and to tie expenditures to a growth rule that allows for inflation and population growth in ongoing spending, and allows for additional spending, for example to meet unexpected mandates and to improve the state's infrastructure. The result is a rate of increase in spending that anchors government at a fixed share of the Arizona economy — growing neither faster nor slower than the overall economy on average through time.

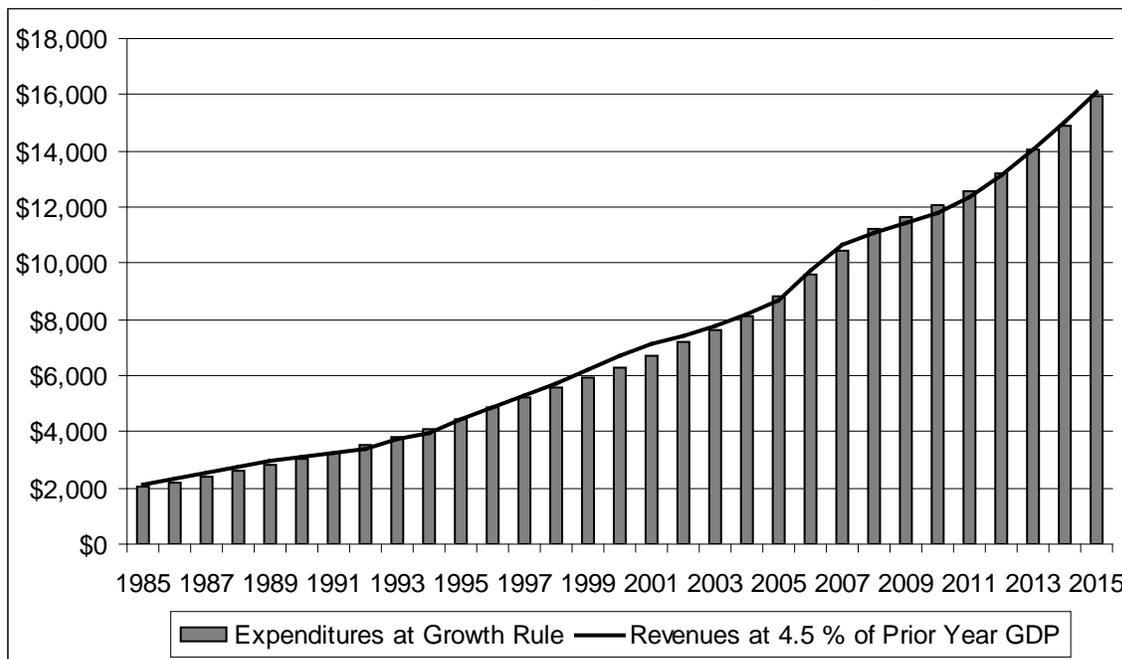
⁶ As to timing, the spending rule for each fiscal year is determined by population growth and inflation for the prior calendar year and the revenue target is 4.5 percent of prior calendar year GDP.

Chart 9 compares revenue and expenditures based on the revenue and spending rules. Since the revenue base is pegged directly to nominal GDP and the spending base also is effectively tied to economic growth, only relatively small fiscal imbalances occur over time. Surpluses and deficits by year are shown in Chart 10. The cumulative net surplus over the period is about \$2 billion.

The annual imbalances illustrated in Chart 10 are small in comparison to what the state has actually experienced. Had the state had a modest rainy-day fund of 5 percent of the general fund, an ample supply of cash would have been available to weather the 1991 downturn as well as the current more substantial deficits. In practice, after an adequate portion of any annual surplus is deposited into the rainy-day fund, the remaining surplus could be rebated to taxpayers on a one-time basis, or invested in one-time construction projects or seed-money initiatives.⁷

The simulation illustrates a missed opportunity for the state. It also suggests that trend spending and revenue would be about \$11.5 billion in FY 2009, compared to the adopted budget of just less than \$10 billion, and actual ongoing general fund revenue that may total

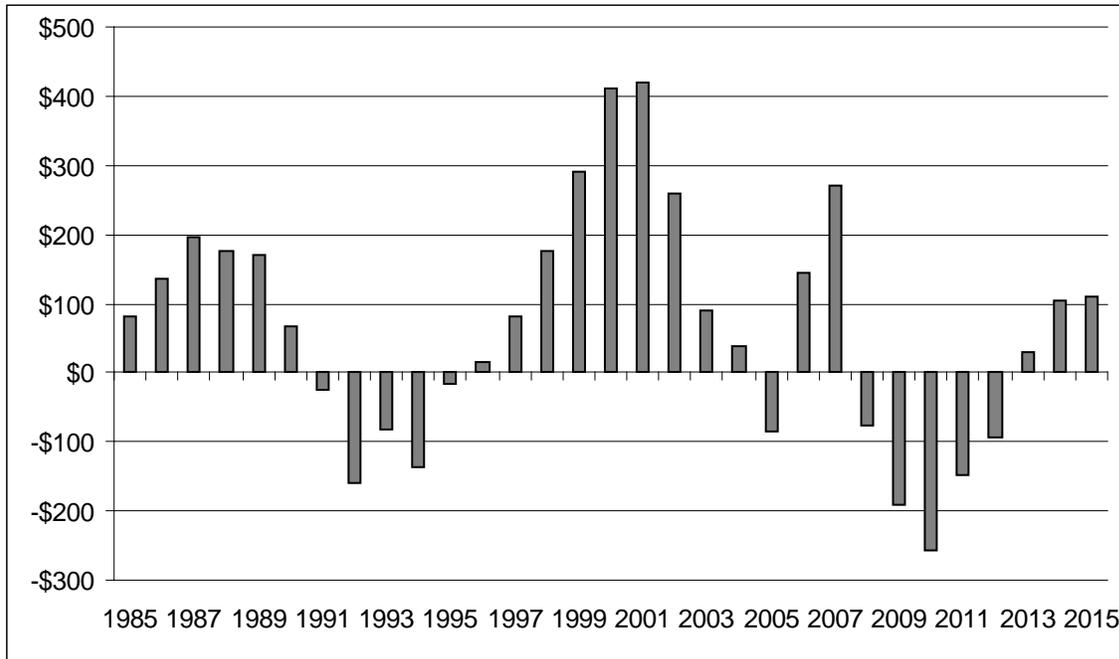
CHART 9
SIMULATED ARIZONA STATE GOVERNMENT GENERAL FUND
EXPENDITURES AND REVENUE AT 4.5 PERCENT OF GDP,
1985 THROUGH 2015 (Dollars in Millions)



Sources: Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

⁷ Compared to current needs, the necessary rainy-day fund balances will be small if the tax base approximates a steady share of the nominal economy. The current general fund revenue base exhibits far more volatility than does the overall economy, so there has been a need for more rainy-day funds historically.

CHART 10
SIMULATED ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE
LESS EXPENDITURES WITH REVENUE AT 4.5 PERCENT OF GDP
1985 THROUGH 2015 (Dollars in Millions)



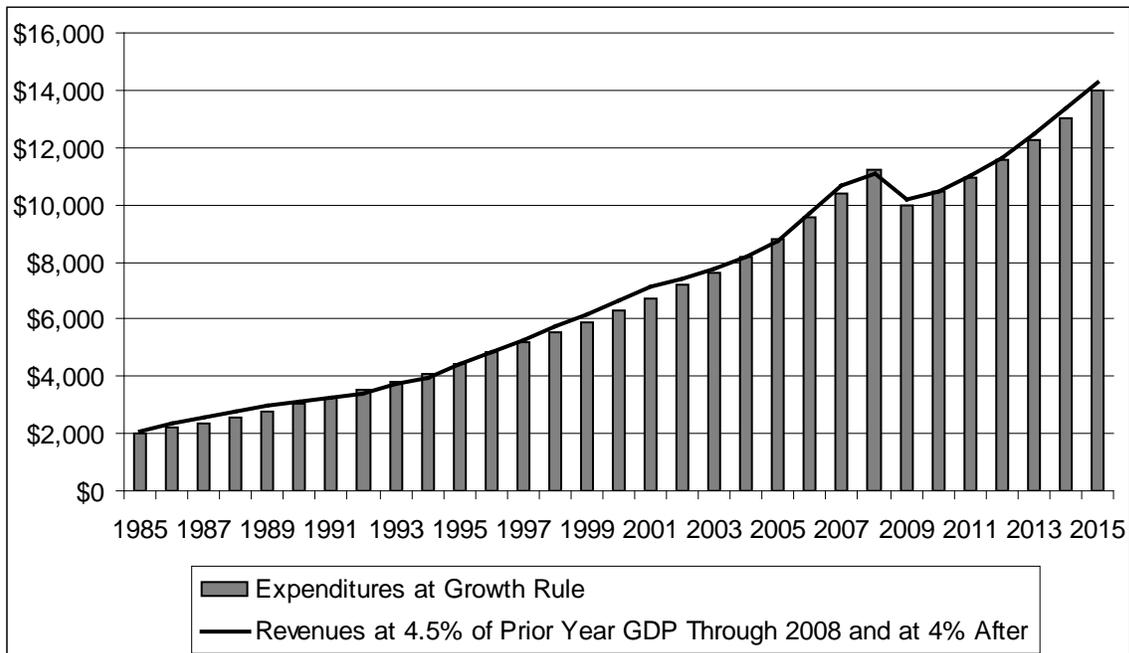
Sources: Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

little more than \$8 billion. The large difference between the trend line and actual revenue suggest that returning revenue to the trend line of 4.5 percent of GDP would require considerable revenue enhancement.

Another possibility is to establish a new “benchmark” for revenue to align with current general fund planned expenditures for FY 2009 of \$9.98 billion. To balance a budget of this magnitude with “on-going” revenue would require revenue to be 4 percent of the estimated 2008 state GDP. If the simulation presented above is adjusted to set revenue at 4 percent of GDP going forward while expenditures follow the same expenditure growth rule, as displayed in Chart 11, the results are similar to the first simulation except that the size of the budget is smaller than that shown in Chart 9. The estimated surpluses and deficits, as depicted in Chart 12, also are similar in nature to those in the first simulation. This illustrates that the very large deficits of the current economic down cycle are eliminated in option 4, as spending as a share of the Arizona economy remains well below its historical norm.

The implementation of this new way to target revenue and expenditures will require the same fixes to the existing structural deficit discussed in the third option. A number of alternatives to accomplish that task are discussed beginning on page 22.

CHART 11
SIMULATED ARIZONA STATE GOVERNMENT GENERAL FUND
EXPENDITURES AND REVENUE AT 4 PERCENT OF GDP
1985 THROUGH 2015 (Dollars in Millions)



Sources: Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

Implementation Issues in Option 4

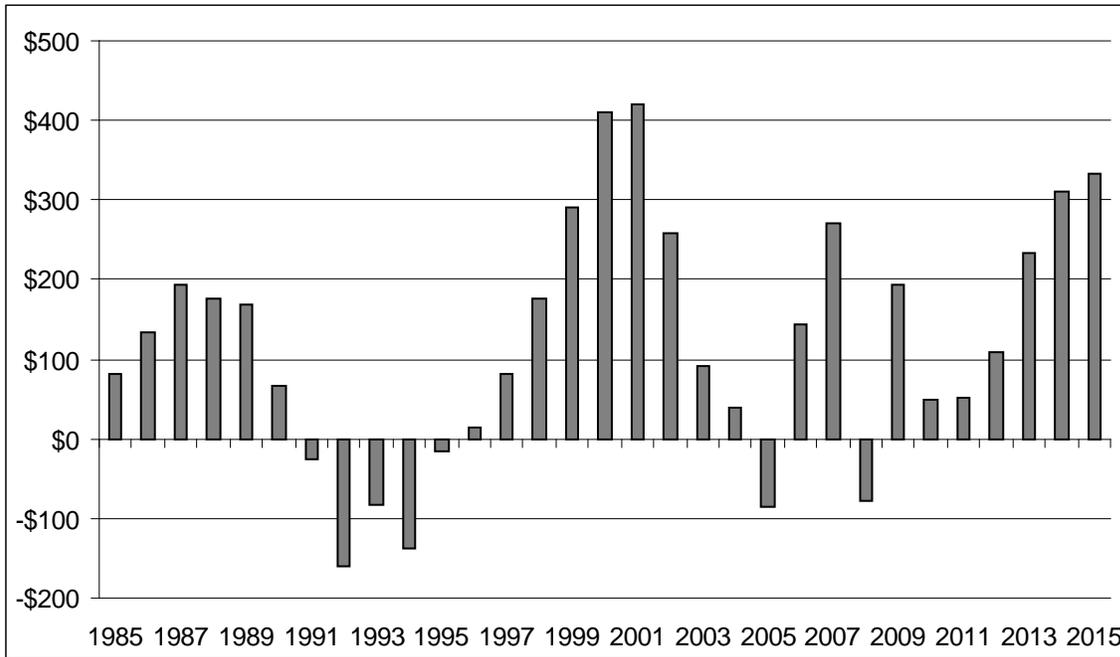
An important issue in implementing option 4 will be to establish the target level for revenue generation. Should it be 4 percent of GDP, the recent norm, or 4.5 percent of GDP, the historical average? It would be prudent to select a relatively high target initially. If excess revenue is collected (after deposits to the rainy-day fund are made), the surplus could be returned to taxpayers.

Once the target is established, the challenge is to select among the proposed changes to the revenue system a bundle that provides a relatively stable revenue stream that grows with the economy. Among the issues is whether there should be trigger mechanisms in the tax code, designed to automatically adjust tax rates, that help in maintaining the targeted revenue yield. Addressing these issues will require considerable work.

Some may argue that adopting a 4-to- 4.5 percent GDP target is infeasible because it will require a tax increase (even if nontax revenues also are increased). The same argument applies to option 3 as well, which, without specifying a revenue target, also will require substantial revenue enhancement in order to remove the structural deficit.

In practice, however, little choice exists. If revenue is not increased and the revenue system is not modernized and made to be less cyclical, the state is unlikely to be able to meet its basic

CHART 12
SIMULATED ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE
LESS EXPENDITURES WITH REVENUE AT 4 PERCENT OF GDP,
1985 THROUGH 2015



Sources: Based on Arizona Joint Legislative Budget Committee (revenue and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (gross product).

obligations, and certainly will not be able to provide for a growing population. An inadequate infrastructure is sure to result, with a lowered quality of life for Arizonans, followed by stagnation in the state’s growth.

The state’s revenue system is in desperate need of reform following 15 years of tax cuts that did not adequately consider the effects of the reduced revenue and which destabilized the revenue stream and caused it to not keep pace with economic growth. The current revenue base does not serve the needs of either the business community or the citizens of the state. There should be no expectation that the tax cuts already passed will stimulate revenue in the future. Not only has this not happened to date, but a rationale for this occurring in Arizona does not exist, as discussed in Volume II.

The particulars of the spending rule could be made more or less complex depending on the definition of “core” needs. The essential ingredient is that the spending rule will need to tie expenditures to the overall growth of the state as measured by personal income, gross product, or another aggregate economic measure. Together with a fixed revenue growth rule, this spending rule will allow the state to live within its means while meeting the needs of a growing Arizona.

The fiscal rule suggested in option 4 may be mistaken by some for the Taxpayer Bill of Rights (TABOR) that resulted in turmoil in states like Colorado. TABOR rules that tie revenue growth

to the sum of annual population and inflation growth rates were established in a concerted attempt to insure that the size of government *falls* as a share of the overall economy. No evidence has been found of any government that has maintained such rules successfully through the course of the business cycle.

In Arizona, a pure TABOR rule would have resulted in revenue and expenditure growth of about 5 percent per year from 1985 to the present. The size of the general fund would have decreased from about 4.5 percent of GDP in 1985 to about 2.7 percent of GDP currently. Option 4 differs from TABOR by adding real per capita economic growth to the formula and by not tying revenue to growth in the prior year.

EXPANDING REVENUE TO CLOSE THE STRUCTURAL DEFICIT

Even if all of the recommendations related to the budget stabilization fund and other contingency funds were adopted (option 3 on page 14), or if the alternative budget plan were implemented (option 4 on page 16), the current structural deficit between general fund revenue and expenditures must be closed. Not closing the structural deficit would result in significant budget deficits beyond those resolved by the BSF in every economic downturn.

One way to close the structural deficit would be to reduce spending from the general fund. One option to reduce spending obligations from the general fund is presented in the next section of this paper: widening the use of bonding for school construction and other capital projects. More commonly defined spending cuts are not discussed in this paper since government spending in Arizona already is quite low. The structural deficit results from very substantial cuts in tax revenue since the early 1990s that were not matched in size by reductions in expenditures.

Several options for enhancing revenue are discussed in the following subsections:

- reducing the use of tax credits and exemptions
- increasing the reliance on user fees
- intensifying the use of federal funds
- enhancing tax collections.

Aspects of these options were included among the recommendations of the Citizens' Finance Review Commission in 2003, even though the purpose of the CFRC was *not* to enhance revenue or resolve any structural deficit. A combination of options for enhancing revenue most likely will be the preferred means of eliminating the structural deficit. The goal should be low tax rates on a very broad tax base.

The estimated amount of revenue to be raised from each of the options discussed below is based on economic models and analysis conducted by the authors, using data obtained from the JLBC and Arizona Department of Revenue (DOR). Before any particular action is undertaken, estimates of the impact of these alternatives should undergo the normal scrutiny of JLBC, DOR and Office of Strategic Planning and Budgeting staff.

Each of the options discussed below is scalable in the sense that different revenue amounts could be raised. For illustration, tax alternatives in bundles of approximately \$500 million per year in current dollars were assessed where possible. However, many of the possible alternatives will not be capable of raising such an amount of revenue, at least without adopting tax rates higher than recommended. While estimates of the size of the structural deficit differ, it probably exceeds \$1 billion per year. Given the high cyclicity of the economy, the actual annual budget over an economic cycle will vary from strong surpluses to severe deficits.

The process of resolving the structural deficit will take time: to conduct thorough research and for proposals to work their way through the decision-making process. Even after such decisions are made, the revenue from most of the options will not be realized immediately. Thus, this process will take too long to resolve the deficit in the state general fund in the current fiscal year (2009) of more than \$1 billion, and results may not be available to resolve any deficit in the following fiscal year.

With most of the “easy” budget fixes already in use — in order to balance the budget in fiscal year 2008 — and with little time remaining before the end of the fiscal year on June 30, few of the revenue enhancements discussed in this paper will be available to solve the current year’s budget dilemma. The current deficit will largely need to be closed through spending reductions. However, the next subsection discusses one option that would enhance revenue in the current fiscal year and would help significantly to resolve any budget deficit in the following year.

Implementing a Short-Term Budget Fix

The projected state general fund budget deficit for the current fiscal year is \$1.2 billion, though a deficit will occur if economic conditions continue to deteriorate. For perspective, appropriations from the general fund are just short of \$10 billion. According to the Governor’s Budget Management Plan issued on October 1, approximately \$170 million is available to transfer into the general fund from the rainy-day fund and from other funds. In addition, the plan states that at least \$75 million is available from unspecified “additional budget management options.” Considering these monies, the projected size of the remaining shortfall is closer to \$1 billion.

Only one source is likely to be able to provide a significant influx of revenue during the current fiscal year: an increase in the transaction privilege (general sales) tax rate. Yet, Arizona is already over-reliant on the general sales tax, which as currently structured in Arizona has a series of significant limitations and negative side effects (discussed later in the subsection on broadening the sales tax base). Thus, an increase in the general sales tax rate should be viewed as a stop-gap measure that should not continue beyond the current economic downturn.

The statewide sales tax rate currently is 5.6 cents per dollar, including 0.6 cents dedicated to education in proposition 301. Over the course of a year, increasing the rate a full cent on the current distribution base under current economic conditions would generate approximately \$850 million for the state general fund and an additional \$230 million to be distributed to counties and municipalities. Many of these local governments also face a significant budget deficit.

However, the amount raised to help balance the current year budget deficit will be considerably less given that the increase could not be implemented until well into the fiscal year. Further, in order to mitigate the increase in tax burden on low-income households, a portion of the revenue generated by a 1 cent surcharge should be returned via a low-income tax credit. Thus, implementing a general sales tax surcharge will not be adequate to balance the FY 2009 budget. Substantial spending cuts will be needed as well. However, a sales tax surcharge should significantly reduce any budget deficit in FY 2010.

The surcharge should expire between the end of calendar year 2010 and the end of fiscal year 2011. This would provide policymakers two years to adopt permanent changes to revenue and/or expenditures that would close the structural deficit. If any of the proposed changes need to be placed before the general electorate, ballot measures could be prepared for the November 2010 election.

The advantages of this proposal are that an increase in the sales tax rate is simple to administer, the sales tax is one of the few sources of tax revenue that has received support in recent public opinion polls, and it is the fastest way to enhance revenue. In addition, consumption taxes

conceptually are economically efficient and create fewer distortions than income or property taxes.

An increase in the sales tax rate, however, would worsen existing negative effects. The 1 cent surcharge would bring the overall sales tax rate — including state, county, and municipal sales taxes — to more than 9 percent in some large Arizona cities.

Increasing the Reliance on User Fees

The state charges fees for industries it regulates and some of the services it provides. Conceptually, fees and charges are designed to align the cost of a particular public service with the use of the service. In contrast, taxes are typically designed with respect to broad bases and provide revenue to support an array of public services.

A system of fees and charges is most efficient when the cost of the charge provides sufficient revenue to support the delivery of a quality service. Inefficiencies can arise when departments assigned the role of delivering the service are partially funded from the charges and partially funded from general revenues. Problems also can arise from charge and fee structures that are fixed through time with no allowance for inflation or other pressures on the cost of service delivery.

In FY 2008, the JLBC category of “licenses, fees, and permits” accounted for only 1.6 percent of the state general fund revenues. However, using FY 2006 data from the U.S. Census Bureau, whose accounting system incorporates other funds than just the general fund, current charges accounted for 6 percent of state government revenues. The local government share was higher at nearly 14 percent. (By state, revenue and expenditure authority varies between the state government and local governments, so the figures for local governments must be examined even if the focus of the analysis is the state general fund.)

As defined by the Census Bureau for FY 2006, per capita state government current charges in Arizona were only half the national average, and the local government figure was 26 percent less than average. The shortfall was \$230 per person at the state level and \$175 per person among local governments. If the per capita dollar figures had equaled the national averages, Arizona’s revenue from current charges would have been \$1.4 billion higher for state government and \$1.1 billion higher for local governments.

Nationally, the largest category of current charges is higher education. In Arizona, state government collections were 23 percent less than the national per capita average, but the local government figure was 45 percent higher. The combined figure was 15 percent less (\$42 per person). If the combined per capita dollar figure had equaled the national average, Arizona’s current charges from higher education would have been \$258 million higher.

Arizona’s low overall collection of current charges relative to the U.S. average is in part explained by the relatively small number of public hospitals in the state. However, even after excluding the hospital category, current charges on a per capita basis at the combined state and local government level in Arizona were 25 percent below the national average in FY 2006. The state government figure was 35 percent below average. If the combined per capita figure had

equaled the national average, collections would have been \$633 million higher. Thus, even after excluding the hospital and higher education categories, Arizona governments collected \$375 million less in current charges than if the per capita figure had equaled the national average.

According to the CFRC, “Based on comparative data of certain fees and a recent report of aggregate fees collected for services of the states, the commission believes that the fees charged do not accurately reflect the fair market value of the services provided or even cover the real cost of providing the service.” As a result, certain groups receive services subsidized by taxpayers. Therefore, the CFRC recommended that “The state should hire a consultant to examine the fairness and extent of miscellaneous taxes and fees imposed by the state for services.”

In addition to comparisons with rates charged in other states and with the cost of service delivery in Arizona, a study of user fees also should consider strategic objectives. For example, in the evolving knowledge economy, higher education is more important than ever, yet higher education funding in Arizona is faltering at the same time that the higher education price index is rising at a faster rate than overall inflation. Significant investment in higher education may require higher tuition assessments. Another example is the transportation infrastructure. Costs of building and maintaining the transportation infrastructure have increased rapidly in recent years and Arizona has made limited investments in the last 15 years. For the state to make significant investments in transportation projects in the future, a greater application of user fees may be required.

Intensifying the Use of Federal Funds

Federal funds are a significant source of state and local government funding. In FY 2006, using the broad Census Bureau accounting, federal funds accounted for one-third of state government revenue and nearly one-fourth of combined state and local government revenue. Despite these high shares, Arizona’s receipt of federal funds is below average.

In FY 2007, federal grants to Arizona governments on a per capita basis were 10 percent less than the national average. The per person shortfall in Arizona of \$166 multiplied by the number of Arizona residents results in a shortage of just more than \$1 billion relative to the national average.

Arizona’s per capita grant receipts were at the national average from the federal Department of Health and Human Services, which accounted for 57 percent of the grants nationally. Arizona’s per person figure from the U.S. Department of Education, which was responsible for 7 percent of the grants, was a little above average, while it was below average by a similar degree from the U.S. Department of Agriculture. In contrast, Arizona’s per person receipts were more than 30 percent below average from the U.S. Department of Housing and Urban Development, from the U.S. Department of Transportation, and from the balance of the federal funding sources. Arizona’s shortfall amounted to \$541 million from Transportation, \$250 million from HUD, and \$298 million from other sources.

One of the CFRC recommendations was “The state should centralize information about federal funds in an effort to increase the federal grant dollars it receives.” This recommendation was based on information that Arizona consistently receives relatively little federal grant dollars

compared to other states, and that Arizona uses a decentralized method of managing federal funds.

The primary way to increase federal funding is to participate in more programs in which the federal government matches local spending. In many programs, the federal government matches a dollar spent by the state with more than \$1 of federal monies. Congressional action also might direct more federal monies to Arizona.

Enhancing Tax Collections

The CFRC recommended that “The state should remove the constitutional requirement that raising tax rates requires two-thirds affirmative vote, reverting to a simple majority requirement.” The CFRC’s rationale was that this requirement will hinder comprehensive revenue reform and argues that the requirement was not intended to make changes such as a revenue-neutral broadening and lowering of the general sales tax rate more difficult to accomplish. Further, the CFRC noted that this requirement narrows the Legislature’s authority on one of the most important tasks for which its members were elected.

The requirement for two-thirds of the members to approve a tax increase will make it very difficult for the Legislature to pass a tax increase. Voters have been more responsive to tax increases for specific purposes (for example, the increase in the tobacco tax to benefit health issues, the increase in the general sales tax to benefit education, and the increase in the general sales tax in Maricopa County to support transportation), but the general anti-tax attitudes of the electorate also present challenges to implementing a tax increase.

For these reasons, strong consideration should be given to enhancing general fund revenue through options not subject to the supermajority vote. However, the supermajority applies to removal of tax credits and exemptions as well, and the amount and timing of funding that might result from other strategies, such as boosting federal funds, is less certain.

The following discussion of enhancing tax revenue first looks at the three primary sources of tax revenue for state and local governments, then discusses lesser sources of tax revenue. It does not represent a recommended order.

Broadening the General Sales Tax Base

While the term “general sales tax” is used in this report, Arizona really levies a “transaction privilege tax” (TPT). The difference between the two taxes relates to the legal burden for remitting the tax. In Arizona, the seller is responsible for remitting to the state the entire amount of transaction privilege tax due. “Selective sales taxes,” discussed later, are not part of the general sales tax.

The TPT is part of the broader JLBC category of “sales and use” taxes. Use taxes apply to goods purchased in states without a sales tax and to several specialized categories, such as a mining severance tax. The TPT is applied to 16 categories, with the tax rate the same (5.6 percent) in most of the categories. “Retail” accounts for 46 percent of the revenue and the restaurant and bar category contributes 8 percent. The other major category is contracting, which generates 22

percent of the revenue. The revenue from the state tax is shared with counties and municipalities through a complex system of formulas.

Background. As in much of the nation, the general sales tax rate has climbed over time in Arizona, with increases in the statewide rate and in the rates assessed by local governments. The current statewide rate of 5.6 percent is in the middle of the 45 states that apply a general sales tax. County and municipal sales taxes can push the overall sales tax rate to more than 10 percent in some communities.

Despite the increases in the overall tax rate, several legislative changes over the past 15 years have lowered collections from the TPT. In 1993, the commercial lease tax was eliminated at a cost at the time of \$96 million. New tax exemptions, particularly in the early 1990s, took millions of additional dollars from the revenue stream. In 1996, the prime contracting sales tax was lowered, at a cost of \$30 million.

Arizona is among the 31 of 45 states that applies a general sales tax but excludes food intended for consumption at home from taxation. Several of the states that tax food do so at a lower rate than that of other items, or offset the tax by offering a rebate or income tax credit to low-income households. Almost all of the states, including Arizona, that assess the general sales tax exclude prescription drugs.

The general sales tax in Arizona is applied largely to goods, not services, and does not reflect the 21st century economy. Indeed, the general sales tax code was written in the 1930s when goods made up a much greater share of consumer purchases. As consumer spending has shifted from goods to services, growth in general sales tax collections have not been keeping pace with the growth of the economy because of the tax's dependence on goods. The general sales tax is a highly regressive tax: lower-income people pay higher shares of their income in sales tax than do higher-income consumers.

Despite its narrow base, Arizona is heavily reliant on the general sales tax. Though the statewide rate is in the middle of the states, per capita state government collections in FY 2006 were 15 percent (\$112) higher than the national average, according to the Census Bureau data. Per capita local government collections were 83 percent (\$154) higher than the national average. Arizona's general sales tax collections were \$687 million higher based on the statewide tax and \$952 million higher based on local taxes than if the per capita dollar figures had equaled the national averages.

The District of Columbia annually produces a "Tax Rates and Tax Burdens" report in which it compares tax burdens in the largest city of each state and in the District of Columbia for four types of taxes — sales, property, income, and automotive related — for each of five income levels: \$25,000, \$50,000, \$75,000, \$100,000, and \$150,000. Using 2007 data, the sales tax burden in Phoenix was second highest at four of the five income levels, and highest in the other.

Given these high figures and Arizona's collections from income and property taxes being substantially below average, the state is unusually dependent on the sales tax. According to the JLBC, 50 percent of the general fund revenue in FY 2008 came from the general sales tax. Using

the broader Census Bureau accounting, the dominance is not as high, but 23 percent of all state government revenue came from the general sales tax.

General fund revenue from the sales and use tax totaled nearly \$4.4 billion in FY 2008. This figure does not include revenues from the 0.6 percent of the sales tax that is earmarked for education, nor does it include the monies distributed to local governments.

Exemptions. Many sales tax exemptions have been passed since 1980. According to the Morrison Institute of Public Policy, the number of exemptions rose from 22 in 1980 to 121 in 1999. The Arizona Transaction Privilege Tax Exemption Study Group that met around 2001 identified 194 exemptions and omissions, recommending that 79 be retained, 113 repealed, and further study done on two. Estimated revenue from the repeal of the 113 exemptions exceeded \$900 million.

The CFRC counted more than 220 exemptions in 2003. It did not do an in-depth study of the exemptions, but noted that “a number of exemptions seem to be ineffective, inexplicable or unique to Arizona’s tax code.”

Using a broad definition of exemptions, the JLBC has estimated that \$8.7 billion in additional revenue could be raised at a 5 percent tax rate if all exemptions were ended. Some of the largest dollar effects are from exemptions that likely should not be eliminated, such as health care, business services, professional services, and wholesale trade. Still, the potential revenue enhancement from broadening the sales tax to include some services and by removing other exemptions reaches into the billions of dollars.

Guiding Principles. As currently structured, Arizona’s general sales tax compares poorly against the fiscal guiding principles adopted by the CFRC. Its narrow base — primarily nonfood goods — introduces cyclicity in the revenue flows, lowering stability and predictability. The tax’s responsiveness is poor since it does not include many services that are growing in popularity. Its efficiency is poor given its high and variable state and local rate by jurisdiction and its narrow base. The high state and local tax rate hinders economic competitiveness by raising the cost of doing business — since purchases by businesses are taxed as well as those by individuals. The large number of exemptions negatively affects neutrality and horizontal equity, and vertical equity is poor because of the high regressivity. Finally, the general sales tax is highly complex given all of the exceptions and the differing rates and bases by community.

Recommendations. Broadening the tax base, reducing the number of exemptions, lowering the tax rate, and simplifying the tax code would move the general sales tax from its current poor evaluation to a strong performance relative to fiscal guiding principles. Several of the CFRC’s recommendations addressed these issues:

- “The state should align the transaction privilege tax to more appropriately mirror the state’s economy by expanding the tax base.”
- “The state should broaden the transaction privilege tax base by including ‘personal’ services or ‘consumer’ services.”
- “The state should broaden the transaction privilege tax base by including certain transactions that currently are tax exempt.”

- “In conjunction with eliminating certain exemptions and broadening the transaction privilege tax base, the state should lower the rate accordingly.”
- “Each transaction privilege tax exemption should include a sunset provision to periodically compare the public policy supporting the tax exemption against the evolving state of the state.”
- “The state should establish high-level tax policy guidelines to be used to test the soundness of future proposed transaction privilege tax exemptions.”
- “The cities and state should pursue greater transaction privilege tax uniformity.”

The first of the CFRC’s recommendations recognizes that the current tax base of the general sales tax is outdated. The second CFRC recommendation of expanding the general sales tax base to include most personal or consumer services is the solution to the narrow and outdated tax base. The CFRC found that more than \$100 million would have been raised in FY 2001 from a limited number of services for which estimated revenue was available. The Commission did not recommend applying the tax to professional services due to complexity of allocating the site of the professional service, and also recommended against extending the tax to business-to-business services because of the risk of double taxation.

The third recommendation is to eliminate some of the general sales tax exemptions, beyond those that can be classified in the second recommendation of broadening the base to include some services. The fourth recommendation to lower the rate acknowledges the prevailing belief that low taxes on a broad base are better than high taxes on a narrow base, and also acknowledges the high current tax rate.

The Commission recommended implementing a sunset provision since an exemption that may once have served a public-policy purpose may no longer do so due to changes in the state’s economy, population, and society. This would create a regular review of sales tax exemptions as already provided in statute for income tax credits. The purpose of the last of the recommendations is to bring simplicity to the currently complex administration of the sales tax by jurisdiction.

Possible Revenue Enhancement. Current estimates of the revenue that would be raised by widening the general sales tax base from \$111.6 billion to \$151.6 billion come to \$2 billion at the existing 5 percent tax rate. Given the sharing of revenue with local governments, the state general fund revenue would be less than \$1.6 billion. The net gain in revenue would be less if low-income tax credits were adopted to lessen the regressivity. Such tax credits would be especially important if food to be consumed at home is taxed. In addition, it is likely the tax base would not be expanded this much, as some of the goods and services currently exempted but recommended to be taxed doubtlessly would end up not being incorporated into the tax base.

The largest revenue producer from the expansion of the sales tax base would be to tax the wage and salary portion of the price of construction: \$640 million. (Currently, 35 percent of the price of a house is exempt from the tax.) Taxing food for home consumption would raise more than \$470 million, and reinstating the tax on commercial leases would bring in \$380 million.

Alternatively, if the expansion of the sales tax base were undertaken with the objective of raising no new money, the state sales tax rate (not including the 0.6 percent from proposition 301) could be reduced to approximately 3.67 percent and raise the same revenue that 5 percent raises on the current base.

An alternative would allow the tax rate to be reduced while still raising additional revenue. For illustration, if the statewide tax rate were reduced from 5 percent to 4.4 percent, collections — prior to distribution to local governments — would increase by approximately \$1.09 billion. Including the proposition 301 tax rate of 0.6 percent, the combined general sales tax rate would be 5 percent — a 10.7 percent reduction in tax rates. Current retailers, who would be responsible for close to two-thirds of the revenue under the expanded tax base, would experience a tax reduction. Combined state and local rates would vary depending on whether local governments adopted the broader base and whether they set their rate to be revenue neutral or to realize an increase in revenue.

Under the existing conditions, a gain in revenue of \$1.09 billion would result in an increase of about \$860 million to the state general fund, with the remainder distributed to counties and municipalities. However, if instead 87 percent of the additional revenue was retained in the state general fund — the distribution currently applied to the contracting and utilities categories — the state general fund would retain approximately \$950 million, with the other \$140 million distributed to counties and municipalities.

If the education earmark of 0.6 percent is applied to the expanded tax base, an additional \$240 million for proposition 301 recipients would be realized. A decision could be made whether to expand the benefits of proposition 301 to other types of education (e.g. universities and community colleges).

If the sales tax base is broadened, policymakers would be prudent to set a rate above that desired to raise a particular revenue level. This higher rate would help offset any slight reductions in the demand for the newly taxed services. The extra revenue also could be used to mitigate any regressivity induced by the imposition of taxes on services and food that are consumed in greater proportion by lower-income households. With properly administered low-income tax credits, low-income households could be unaffected by the new taxes on services and food.

Prior efforts to broaden the sales tax base have not gone far. Businesses that would collect and remit service taxes have protested effectively. However, arguments that a tax on services will hurt small businesses fail to acknowledge the inherent inequities that prevail today between small retailers (currently taxed) and small service providers (not currently taxed). If care is taken in deciding which services should be taxed, then consumers will be left with a choice of paying more for the service or not purchasing the service at all. Further, all businesses would benefit from a lower tax rate.

Reducing the Use of Income Tax Credits

Tax credits are subtracted directly from tax liability on a dollar-for-dollar basis. A number of tax credits are present in the corporate income tax code and in the personal income tax code. Some of the tax credits implemented by the Legislature are available only for a few years, so the

number available is constantly fluctuating. The CFRC recommended that all but five of the 14 corporate tax credits, and all but six of 24 individual income tax credits, that were available in 2003 be phased out. Eliminating a tax credit has been interpreted as the same as a tax increase, requiring a two-thirds approval of the Legislature.

More generally, three of the CFRC's recommendations were related to tax credits:

- “The state should have as few corporate and personal income tax credits as possible.”
- “The state should review the effectiveness of private school tuition tax credits and the extracurricular public school tax credit.”
- “The state should retain certain low-income tax credits.”

The first recommendation is a broad philosophical statement based on the fact that tax credits violate two of the guiding principles of a fiscal system:

- Neutrality: Differential treatment of similar economic activities should be minimized.
- Horizontal equity: People of equal means should be treated equally.

The second recommendation reflects the controversial nature of these tax credits and the relatively large amount of monies not deposited in the general fund due to these credits.

The third recommendation is an acknowledgment of the regressive nature of many taxes and the philosophy that tax policy should not cause economic distress. Three low-income tax credits are currently available: (1) family income credit, designed to alleviate the income tax burden, (2) credit for increased excise taxes paid, designed to mitigate the effect of the 0.6 percent increase in the general sales tax resulting from proposition 301, and (3) property tax credit, designed to reduce the property tax impact on senior citizens.

Corporate Income Tax Credits. Until 1981, no corporate income tax credits existed. By 1999, there were 18, but the number had dropped to 14 in 2003. According to the CFRC, more than \$30 million in credits was claimed in 2000, but nearly \$100 million in credits were available. The Commission noted that “it appears most of the corporate tax credits are ineffective at promoting the anticipated behavior or outcome and some, like the alternative fuels credit, had unexpected, adverse outcomes.”

According to the 2008 version of the Tax Handbook produced by the Joint Legislative Budget Council, 27 corporate income tax credits are listed, but three no longer can be claimed. Data availability on the estimated effect of each tax credit varies, but the JLBC indicates that the general fund did not realize \$59 million in claimed tax credits in tax year 2005 of \$272 million in certified credits.

Personal Income Tax Credits. The cost to the general fund was modest of most of the 18 individual income tax credits that the CFRC recommended eliminating due to being ineffective or lacking accountability measures. However, the two private and public school credits that the CFRC suggested be reviewed took \$45 million out of the general fund in 2001.

According to the 2008 Tax Handbook, 31 personal income tax credits are listed, but three no longer are available. In tax year 2006, the last year for which reasonably complete data are

available on the overall effect of the credits, the credits removed \$252 million from the general fund. Currently, tax credits account for approximately \$300 million in individual income tax offsets, using estimates from the Arizona Department of Revenue. However, the true cost may be higher since as many as nine credit categories have no estimates of costs. Understanding just how much tax is actually lost due to these credits is challenging because it is difficult to predict the economic activity that would take place in their absence.

The suspension of public and private school tax credits might be expected to yield approximately \$100 million — \$93 million was claimed in tax year 2007. These credits were instituted during a period when the general fund had a surplus. Their existence diverts money from the general fund that now appears to be unable to cover the costs of basic state services.

Raising the Personal Income Tax Rate

Like most states, Arizona levies both an individual income tax and a corporate income tax. Increasing the corporate tax rate is not discussed in this paper since it is not viewed as an option for enhancing state government revenue. The corporate income tax does not compare favorably to the fiscal guiding principles; in particular, revenue is highly volatile. Further, business taxes in Arizona already are high relative to taxes on households.

Background. Individual income tax rates in Arizona have been reduced several times since the early 1990s, resulting in a very large cumulative decline — even considering earlier tax increases passed in 1989 and 1990. Rates currently are about 35 percent lower than in 1990. The first large tax cut was passed in 1994; once fully phased in, the JLBC estimated its impact at the time as an estimated \$107 million. Subsequent large reductions occurred in 1995 (\$200 million), 1997 (\$111 million), 1998 (\$50 million), and 2006 (\$334 million). Other changes to the individual income tax code, including the implementation of numerous tax credits, lowered revenue further over the last 15 years.

The complexities of the income tax code make it difficult to compare tax rates from one state to another. Most states have a progressive structure where the tax rate increases with income. But the number of tax brackets and the dollar range of the brackets vary widely by state. Other features differ by state as well, including the amount of personal exemptions (if any) and deductibility of various items, such as health care expenses and federal income tax paid. A few states — but not Arizona — allow a local income tax to be levied in addition to a state rate.

However, all studies that have compared the personal income tax liability in Arizona relative to other states show that the tax burden in Arizona is quite low. According to the 2008 District of Columbia study using 2007 tax rates, nine states do not levy an income tax. Among the remaining states and District of Columbia, Arizona (Phoenix) ranked second to last in the two highest income levels, and fourth or fifth lowest at the second and third highest income levels. In contrast, at the lowest income level, Phoenix was at the median of the 51 cities (though the tax burden was only \$123).

According to Census Bureau data for FY 2006, the per capita personal income tax collection of state and local governments in Arizona was 41 percent below the national average, with state

government 36 percent below average. If the combined per capita dollar figure had equaled the national average, Arizona's collections would have been \$2.3 billion higher.

Using the JLBC definition of the general fund, personal income tax revenue of \$3.4 billion accounted for 39 percent of total revenue in FY 2008. However, this overstates the impact, since a portion of both individual and corporate tax collections are shared with cities. The net revenue from the individual and corporate income tax combined was \$3.5 billion (40 percent of the total general fund revenues). Using the Census Bureau data, the individual income tax provided only 14 percent of the state general fund revenue in FY 2006; the share was only 9 percent for state and local governments combined.

In recent years, the volatility of capital gains has greatly affected the stability of income tax revenue. Net capital gains reported by Arizonans to the Internal Revenue Service peaked at \$8.4 billion in 2000, fell to \$3.6 billion in 2002, then soared to \$15.2 billion in 2006, the latest data. With the real estate bust and the weakness in the stock market, current figures certainly are much lower.

Guiding Principles. The personal income tax currently compares more favorably against the fiscal guiding principles than the general sales and property taxes, but less opportunity exists for improvement. Reducing the number of credits and exemptions would improve the neutrality of the personal income tax. Tax brackets should be indexed for inflation. With personal income tax rates lower than in much of the nation and lower than in Arizona in the past, raising these rates would help to restore balance among the three major tax sources. Tax rates could be made more progressive, improving vertical equity. However, the wisdom of increasing income tax rates and making the tax rates more progressive is hotly contested among economists.

Recommendations. Apart from recommendations regarding tax credits that have already been discussed, the CFRC made the following recommendations regarding the personal income tax:

- “The state should not adopt a single flat rate for personal income tax purposes.”
- “The state should withhold income tax from non-residents.”
- “The state should follow the federal income tax returns as much as possible.”

Two options for increasing revenue from the personal income tax are discussed below. In the first option, tax rates are increased except among low-income earners, while in the second option, a “fairness” tax is applied to high-income filers paying a below-average proportion of their income in taxes.

Income Tax Surcharge. Endless variations for increasing income tax rates are possible. This illustrative example (see Table 1) raises individual income tax rates by 16 percent for those earning between \$25,000 and \$50,000, by 21 percent for those earning between \$50,000 and \$150,000, and by 26 percent for those earning at least \$150,000. (These are existing income brackets in the state tax code.) The proposed increases still leave the individual income tax rates significantly below the historical levels.

By not increasing the rate among the lower-income brackets, the proposed change is not regressive. The result of implementing this proposal would be an estimated revenue increase of

TABLE 1
ILLUSTRATIVE EXAMPLE OF AN INCREASE
IN INDIVIDUAL INCOME TAX RATES IN ARIZONA

Adjusted Income	Existing Tax Rate	Proposed Tax Rate
Less than \$10,001	2.59%	2.59%
\$10,001 – \$25,000	2.88	2.88
\$25,001 – \$50,000	3.36	3.90
\$50,001 – \$150,000	4.24	5.13
\$150,001 or more	4.54	5.72

Source: Arizona Joint Legislative Budget Committee (actual rates).

\$500 million. Even with this increase, Arizona’s personal income tax liability would be less than in much of the nation.

Despite Arizona’s low personal income taxes, relative to both the rest of the nation and to historical Arizona rates, this proposal is likely to encounter significant resistance. In addition to a generally anti-income tax attitude among the population, some economists strongly oppose the income tax, stating that consumption taxes create fewer distortions than do income taxes.

Further, due to very high volatility in capital gains over the last decade, the income tax has been a volatile source of revenue. Placing a larger burden on higher-income tax filers will increase the volatility of the revenue flows to the general fund.

The Fairness Tax. A review of the abstract of all individual income taxpayers reveals that some taxpayers are able to use existing tax law to reduce their taxable incomes to very low proportions of their adjusted gross incomes. A comparison of the shares of incomes paid in taxes varies considerably for taxpayers with similar incomes. This is the natural result of a tax code that includes numerous opportunities for taxpayers to substantially reduce taxable incomes. Despite the anti-income tax attitude prevalent in Arizona, the fairness tax may have appeal to those convinced that the wealthy do not pay their fair share of income taxes.

A form of alternative minimum tax, the fairness tax could be implemented to ensure that filers at very high income levels pay at least their fair share in total income taxes. The tax burden averages more than 4 percent of Arizona adjusted gross income for filers at high income levels. A minimum tax liability of 4 percent, for example, could be implemented for very high income earners. Imposing this tax on individual incomes of at least \$500,000 and on couples with incomes of \$1,000,000 and above (the marginal tax rate on such incomes is currently 4.54 percent) would have raised about \$49 million in 2006. Applying a fairness tax to those with incomes of more than \$250,000/\$500,000 would have increased revenue \$61 million. The amount raised from a fairness tax will vary with the economic cycle.

Reinstating the State Property Tax

The property tax is a tax on the market value of privately owned property, which may include land, structures, machinery, and other real property, such as vehicles. The tax liability typically is calculated by multiplying the nominal tax rate by the assessment ratio (the percentage of the

value of the property that is taxed) by the value of the property. Within a given jurisdiction, the tax rate and assessment ratio may vary from one category of property to another. The overall property tax rate usually consists of multiple tax rates of several overlapping jurisdictions, such as county, municipality, school district, and special district. The result is a complex system that makes it difficult to compare the property tax from one place to another.

Background. Property taxes across the nation largely are levied by local governments — counties, cities, school districts, and special districts. Arizona levied a statewide tax through FY 1996. Property tax revenues to the general fund fell \$150 million in the following year when the tax was repealed. Since then, the property tax revenue deposited into the state general fund comes from taxes levied on property not located within any school district and on property in certain school districts ineligible for state aid (minimum qualifying tax rate districts).

According to the Joint Legislative Budget Council, property taxes provided only \$20 million to the state's general fund in FY 2008, just 0.2 percent of the total. Using the Census Bureau's accounting system, a greater amount is shown to have been collected by the state general fund. In fact, the per capita state government figure in FY 2006 was much higher than the national average on a percentage basis, but the difference amounted to only \$25 per person. The property tax accounted for less than 2 percent of the state government total revenue.

In contrast, though property taxes accounted for close to one-fourth of local government revenue, local government per capita property taxes were considerably less than the national average. With a differential of \$331, per capita property tax collections of state and local governments combined were 25 percent (\$306) less in Arizona. Arizona's property tax collections were \$1.9 billion lower than if the per capita dollar figure had equaled the national average.

These overall property tax comparisons do not reveal the large differences within the property tax system. Until recently, business property taxes had been quite high relative to residential property taxes. Several legislative measures, currently being phased in, have reduced the property taxes on businesses. Still, the assessment ratio on most commercial and industrial owners in the state will be twice as high as the residential property tax ratio.

Residential property owners in Arizona enjoy very low residential property tax burdens. The tax in Phoenix was about 37 percent below the average major city according to the 2008 District of Columbia tax study. Phoenix ranked 42nd or 43rd at each income level.

The Tax Foundation in September 2008 released a ranking by county of residential property taxes in 2007. Among the 788 counties in the nation with a population of at least 65,000, all 10 Arizona counties included in the listing were ranked below the median on all three measures presented: median property tax assessed in dollars, median tax as a percentage of median home value, and median tax as a percentage of median homeowners' income. Pima County's tax burden was the highest on each measure, with ranks of 455th, 539th, and 444th, respectively. Maricopa County's ranks were 500th, 691st, and 575th.

Guiding Principles. Relative to the fiscal guiding principles, Arizona's property tax system currently has a mediocre rating. Efficiency and competitiveness are negatively affected by the

high property taxes on businesses, neutrality is compromised by different tax rates by category of property, and the system is highly complex, given multiple rates and assessments and large variations by jurisdiction.

Usually, the stability and predictability of property tax collections are strong positive features, but distorted real estate cycles in the 1980s and again in recent years took away these advantages. Apart from these distortions, the responsiveness of the tax is good as property values typically rise with real economic growth.

Recommendations. Several of the CFRC recommendations were related to the property tax:

- “Arizona should re-enact the option of a state property tax, applied on a uniform assessment ratio.”
- “The state should eliminate the 1-percent constitutional cap on residential property tax.”
- “The state should phase out the homeowner’s rebate.”
- “The state should move toward reducing overall business property tax burdens.”
- “The state should reduce the business personal property tax on locally assessed business personal property.”
- “The state should apply a uniform assessment ratio on all future voter-approved property tax-funded bonds and overrides.”

In addition, as discussed in a later subsection on bonding for school construction, the CFRC recommended using property taxes to fund school construction.

The CFRC’s rationale for re-enacting the state property tax largely was related to the stability and predictability of the tax revenue. The desirability to approximately balance the “three-legged stool” of taxation — income, property, and sales taxes — was cited.

The homeowner’s rebate, while initially cited as providing assistance to low-income homeowners, was applied to all homeowners. It represents a subsidy of homeowners by the state. Legislation passed in 2005 is gradually raising the limit from 35 percent of the primary property tax bill to 40 percent, and also is raising the cap from \$500 to \$600. The 1 percent cap on the residential property tax also results in a subsidy by the state general fund.

The fourth and fifth recommendations were included to enhance the state’s economic competitiveness. Similarly, the last recommendation was made to prevent the shifting of the property tax burden to businesses.

Reinstating the statewide property tax generally would improve the overall stability of state government revenue flows. Implementation costs would be low. Further, this would help the exportability of state taxes, as an increasing proportion of the state’s seasonal residents are purchasing dwellings rather than renting or living in recreational vehicles. If the tax were restricted to residential properties, it would further reduce the inequity between commercial and residential taxes. Similarly, reduction of the homeowners’ rebate and 1 percent cap also would reduce the business-residential inequity.

Possible Revenue Enhancement. A statewide property tax of \$1 per \$100 of net assessed value —approximately what the community college system takes in combined primary and secondary

assessments today — can be expected to raise more than \$500 million annually, but some of the revenue should be used to mitigate regressivity. This tax is deductible on federal and state income tax forms.

The roughly \$500 million net estimate includes taxation of commercial and industrial properties. Under the existing tax code, the owner of a residence valued at \$250,000 would pay \$250 per year, but business owners would pay over twice this amount on the same property value.

In an attempt to provide a more level playing field across property classes, the new statewide tax could be applied using a uniform assessment ratio as recommended by the CFRC, which would place relatively more of the burden on residential property tax owners than under the current system. Using a uniform assessment ratio, residential properties would pay about 65 percent of the total tax burden and about \$100 million more than under the existing system. Business property owners would pay \$100 million less and only about 17 percent of the total burden.

Alternatively, a net \$500 million revenue enhancement for the general fund could be attained by an additional 25 cents per \$100 of assessed valuation on the existing property tax base coupled with the phased-out elimination of the homeowner's rebate (probably not starting the phase out until the end of the current real estate recession), estimated in the FY 2007 tax expenditures report of the Department of Revenue at \$366 million, and the elimination of the 1-percent constitutional cap on residential property tax (probably less than \$10 million, if feasible). In this case, residential properties would pay about 80 percent of the total new tax burden.

The proceeds from the reinstatement of the state tax could be used as the source of funds to support the bonding of school construction (discussed in a later subsection).

Boosting Collections from Selective Sales Taxes

Selective sales taxes are tax levies selectively imposed on particular kinds of commodities or services, or on gross receipts of particular businesses. Nationally, the most common are taxes on motor fuels, alcoholic beverages, tobacco products, insurance premiums, and public utilities. Other common targets include parimutuel betting and amusements. Included in the selective sales tax category are accompanying license taxes that may be applied to these selective commodities.

According to the JLBC, the insurance premium and luxury taxes (liquor and tobacco) contributed 5 percent of state government general fund revenues in FY 2008. Proceeds from the motor fuels tax do not go to the general fund. Using the broader Census Bureau accounting (which classifies the motor fuels tax collections as general revenue), selective sales taxes accounted for 7 percent of state government revenue in FY 2006, but only 1 percent of local government revenue. As a whole, per capita collections of selective sales taxes were 28 percent less than the national average for state governments and 36 percent less for local governments. The \$101 per person shortfall in state government cumulates to \$620 million across the entire Arizona population. The local government shortfall amounts to another \$177 million.

One CFRC recommendation addressed selective sales taxes: “The state should replace unit-based fees and taxes with percentage-based fees and taxes.” Without legislative adjustments, which are infrequent, these per-unit sources do not keep pace with inflation.

Motor Fuels. All states apply an excise tax on sales of motor fuels, with the tax rate being on a cents-per-gallon basis. In some states, the tax rate varies slightly between sales of gasoline, diesel fuel, and gasohol. In Arizona, the rate on each type of motor vehicle fuel is 18 cents per gallon, a rank of a tie for 38th among the states. However, the per capita collection in FY 2006 was at the national average. A number of factors could account for this apparent discrepancy: gasoline sales to tourists and seasonal residents, longer-than average distances traveled in Arizona, vehicles with lower average miles per gallon, etc.

The motor fuels tax compares favorably to the fiscal guiding principles. The only strong downside is that it is regressive. Its responsiveness could be improved by indexing the rate to inflation.

The state has not adjusted the tax of 18 cents since 1991. The median of the states is 21 cents, and six states charge more than 30 cents per gallon. Arizona could modestly raise its rate, and the tax should be indexed to inflation to avoid having the rate fall behind in the future. However, this would increase revenue by less than \$100 million and would not help resolve the general fund deficit. It would, however, provide more funding for transportation. Alternatively, the increase in rate could be earmarked to the general fund.

Tobacco. All states levy a tax on cigarettes, but tobacco-producing states have very low rates, resulting in a very wide range in tax rates, from just 7 cents to \$2.57 per 20-cigarette pack. In a few states, counties and cities may impose an additional tax. Other tobacco products such as cigars and snuff also are taxed, but the tax rate is calculated by differing means across the states. Arizona’s \$2 cigarette tax is tied for fourth highest, but per capita collections of the tobacco tax in FY 2006 were marginally less than the national average.

The tobacco tax has a mediocre rating relative to the fiscal guiding principles. Given its high tax rate, its regressive nature, and the declining sales of tobacco products, no increase in the rate is recommended. However, the current rate should be adjusted for inflation going forward.

Alcohol. All states tax alcoholic beverages. In most states, the excise tax is in addition to the general sales tax. Tax rates per gallon differ between beer, wine, and distilled spirits. In addition to the excise taxes, license taxes are included in this subcategory. States may require licenses for manufacturing, importing, wholesaling and retailing alcoholic beverages.

Among the 32 states that allow sales of distilled spirits outside of state-run liquor stores, Arizona’s tax of \$3 per gallon ranks 21st. Of the 46 states that permit sales of wine outside state stores, Arizona’s tax of 84 cents per gallon ranked 18th. Arizona’s tax rate of 16 cents per gallon on beer ranks tied for 30th.

According to the JLBC, the liquor tax raised \$65 million in FY 2008, but less than \$29 million went into the general fund. The alcoholic beverage license tax added \$6 million, with \$5 million

going to the general fund. On a per capita basis in FY 2006, state and local government collections from alcohol taxes in Arizona were 45 percent less than the national average. If the per capita amount had equaled the national average, an additional \$50 million would have been generated.

Except for regressivity, this tax compares favorably to the fiscal guiding principles. Indexing of the tax rates to inflation would improve responsiveness. In addition, tax rates for beer and distilled spirits could be increased without exceeding the national norm. While perhaps \$50 million would be raised, less than half would help resolve the deficit in the general fund.

Public Utilities. This category includes taxes imposed on public utilities, including telephone companies, power companies, and public passenger and freight distribution companies. The taxes are based on gross receipts, gross earnings, or units of service sold. Also included in this subcategory are license taxes on the same types of companies. Tax rates are not consistently applied by type of public utility, thus comparative rate information with other states is not available.

The JLBC classifies these levies as in lieu taxes. Amounts collected generally are small, and some of the revenue does not enter the general fund. According to Census Bureau data for FY 2006, Arizona makes little use of this tax. The per capita collection of state and local governments was 62 percent below the national average, with state government 92 percent below average and local governments 35 percent below average. If the combined per capita dollar figure had equaled the national average, Arizona's collections would have been \$305 million higher.

The public utilities tax compares favorably to the fiscal guiding principles. However, more research is needed before making a recommendation on this selective sales tax.

Other Selective Sales Taxes. Other selective sales taxes include the amusements and parimutuels subcategories, as well as lesser selective taxes such as on fuels other than motor fuel. Some license taxes also are included in this subcategory. In addition, the Census Bureau includes the insurance premium tax in this category.

Per capita collections of all other selective sales taxes by state and local governments in Arizona was 44 percent below the national average in FY 2006, with state government 49 percent below average and local governments 23 percent below average. If the combined per capita dollar figure had equaled the national average, Arizona's collections would have been \$442 million higher, with \$398 million of this realized by state government.

According to the JLBC, collections from most of these taxes are minimal. The exception is the insurance premium tax, which is applied to net insurance premiums received by insurance companies for risks that exist in Arizona. It includes life insurance, health insurance, fire insurance, vehicle insurance, and other insurance. The rate in Arizona generally is 2 percent. The JLBC reports revenues of \$438 million in FY 2008, with \$407 million being placed in the general fund.

More research is needed before making a recommendation regarding the other selective sales taxes.

Raising the Vehicle License Tax Rate

The motor vehicle license tax is an annual tax separate from the one-time sales tax levied when a vehicle is purchased. States use a multitude of methods to determine the tax. In Arizona, a value-based vehicle license tax is assessed in lieu of a property tax.

The Legislature reduced the state portion of the vehicle license tax in 1998 and ended the tax the following year. According to the JLBC, state government revenue from this tax fell from more than \$160 million in fiscal year 1998 to zero in fiscal year 2002. According to Census Bureau accounting, state and local governments in Arizona collected \$192 million from the motor vehicle license tax in FY 2006. The per capita figure was 55 percent below average. Approximately \$231 million more would have been collected if per capita collections had equaled the national average.

The District of Columbia tax burden study includes the vehicle license tax as one of several taxes (e.g. the gas tax) making up its auto category; data for the individual components are not available. Overall, automotive-related taxes in Phoenix are near the national median in the two lowest income levels, but above the norm at the other three incomes.

Relative to the fiscal guiding principles, the vehicle license tax compares quite favorably except in terms of its exportability, since it applies only to residents. More revenue could be collected from this source without adversely affecting competitiveness.

Exploring the Use of Other Taxes

Various other taxes are used in Arizona, including license taxes not included in other categories, severance taxes, and death and gift taxes. Additional taxes are applied in some states but not in Arizona, most notably the real estate transfer tax.

State government in particular uses few of these other taxes. According to the Census Bureau, its per capita collections in FY 2006 were 80 percent less than the national average. Local government collections were 12 percent less than average. Approximately \$958 million more would have been collected if per capita collections of other taxes had equaled the national average, with \$886 million of this realized by state government.

Adopting Other Revenue Enhancements

The Census Bureau identifies four other categories of government revenues:

- Interest earned. In FY 2006, Arizona's per capita figure was 37 percent below average in state government, but the local government figure was nearly equal to the national average. If the per capita dollar figure had equaled the national average, Arizona's interest earnings would have been \$293 million higher for state government.
- Special assessments. This category primarily applies to local governments. Arizona was far below the national per capita average in FY 2006.
- Sale of property. The FY 2006 per capita revenue for state government was far higher than average while the local government figure was a little below average.

- Miscellaneous. In FY 2006, Arizona's per capita figure was 39 percent below average in state government and 16 percent below average at the local government level. If the per capita dollar figures had equaled the national averages, Arizona's miscellaneous revenue would have been \$625 million higher for state government and \$139 million higher for local governments.

The CFRC recommended several actions to improve on the state's fiscal procedures in terms of money management and long-term planning. Two of these have the direct effect of enhancing revenue:

- "The state should decrease revenue loss by increasing spending on revenue enforcement until cost-benefit equilibrium is reached, and by implementing a system that makes tax avoidance more difficult."
- "The state agencies should 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."

It is unclear how much revenue will be enhanced by such actions.

LIMITING EXPENDITURES TO CLOSE THE STRUCTURAL DEFICIT

One way to close the structural deficit would be to reduce spending from the general fund. However, spending cuts are not discussed in this section. Government spending in Arizona already is quite low. The structural deficit results from very substantial cuts in revenues since the early 1990s that were not matched in size by reductions in expenditures.

Other options to reduce expenditures from the general fund are limited. Using long-term debt for school construction and other capital projects is discussed below. Changing distribution formulas that transfer general fund monies to state and local governments would be another option. However, this shifts the problem of balancing the budget from state government to more than 100 county and municipal governments.

Widening the Use of Bonding for School Construction and Other Capital Projects

Historically in Arizona, school construction and renovation was the responsibility of school districts, which financed the construction with local property tax revenues. However, in 1994 the Arizona Supreme Court ruled that this method of funding school construction was unconstitutional, because variations in property values by school district violated the general and uniform clause.

In 1998, the Legislature adopted an alternative funding mechanism, called "Students FIRST." This legislation placed the responsibility for funding capital needs of school districts in the state general fund. With limited bonding available, most of the costs are paid with current year expenditures from the general fund. In most years since the passage of this legislation, the general fund expenditures for school capital needs have been between \$300 million and \$500 million.

This funding mechanism violates the accepted fiscal principle that short-term expenses that benefit current taxpayers should be funded with immediately available revenue, but that long-term capital investments that will benefit generations of taxpayers should be funded through long-term financing. Businesses and individuals alike follow this principle. The purchase/construction of buildings and homes by businesses and individuals are financed using long-term debt unless the purchaser is wealthy (and frequently even then long-term debt is used).

Failure to employ the capital markets in this fashion would leave the private sector with a suboptimal number of completed projects and an underutilization of financial resources. Indeed, economies with poorly functioning capital markets languish because it is not possible to fund major capital items without long-term financing. In contrast, advanced economies with access to efficient, freely functioning capital markets flourish by using financing for capital expenditures. This is one of the key distinctions between first- and third-world economies.

The basic principle of efficient capital budgeting applies to the decision to put public infrastructure in place, be it in the form of public highways, prisons, elementary and secondary schools, water treatment facilities, or university buildings, even though these investments do not yield net revenue from physical plants or production lines. To minimize costs and maximize public benefit, policymakers should make building decisions that consider the advantages of access to capital markets. A newly constructed school can yield direct benefits (analogous to net

revenue in the private sector) to students — many of whom have not yet moved to Arizona or even been born — over the life of the school and indirect benefits to society that span generations. Similarly, roads deliver benefits over their lifetime of use and these benefits accrue to people who have yet to move to Arizona and to future generations. While it is difficult to translate the benefits of public investments into dollars, such benefits certainly exist or new schools or new roads should not be built at all.

Debt financing is an appropriate mechanism for public capital investments because the benefits of the new physical capital extend far beyond the year in which the facility is constructed. For example, financing a school over its lifetime is an efficient way of matching benefits to costs in the same manner that private-sector firms match future net revenue to continuing debt service. Moreover, the students who benefit from new schools, drivers who use the new roads, and families who move to new areas of development include future taxpayers. Failure to utilize debt financing is unfair to current taxpayers — especially the elderly who may not live to realize the benefits — and inefficient since a suboptimal amount of public infrastructure is put in place to serve current and future needs. For more information on debt financing, see the University Economist report “Public Investment Using Debt Financing and the Effect on Economic Activity” from January 2008.

Two of the CFRC recommendations addressed the issue of bonding:

- “The state should utilize capital financing tools (bonding) for long-term capital assets with debt service tied to specific revenue streams.”
- “The state should not depend on general fund revenues to finance new school construction, but instead should implement a process for new school construction using local school district, county or state property taxes.”

The CFRC noted that various options exist to carry out the second recommendation, and that all of the options are preferable to the current financing mechanism. The CFRC made no exception to the use of long-term financing for long-term investments.

However, a rationale for Students FIRST is that from a statewide perspective, the construction and renovation of schools is an ongoing requirement that does not vary much from year to year. In the long term, the debt repayment of the bonding option likely will equal or exceed the annual outlays of the current funding mechanism. That is, the freeing up of cash in the general fund will be substantial in the first year that bonding is used, but will gradually decline over time.

A compromise that accepts this rationale but also considers the strong cyclicity of general fund revenues is to use the existing funding mechanism in years of strong economic growth but to automatically use bonding whenever economic growth slows. An illustration — see Table 2 — of how selective debt financing would have helped the current budget situation follows. Suppose that since FY 1999, school construction was paid in cash during years when the Arizona economy grew rapidly and used debt financing at other times. In this example, expenditures were debt financed in fiscal years 2001, 2002, 2007 and 2008. Assume the difference saved from this program was deposited in the budget stabilization fund. Then the accumulated savings from this program net of all accumulated interest would be nearly \$1 billion, which could be applied to the current budget deficit.

**TABLE 2
ILLUSTRATIVE EXAMPLE OF BORROWING FOR SCHOOL CONSTRUCTION
IN SELECTED YEARS IN ARIZONA**

Fiscal Year	Actual Expenditure from School Facilities Board Account	Assumed Loan Payment for Borrowing the Annual Amount	Total Loan Payments Including Past Years' Obligations	Annual Savings
1999	\$310,893,300	\$ 0	\$ 0	\$ 0
2000	319,062,300	0	0	0
2001	473,965,100	40,000,000	40,000,000	433,965,100
2002	383,591,800	30,000,000	70,000,000	353,591,800
2003	39,821,200	0	70,000,000	0
2004	21,375,300	0	70,000,000	0
2005	218,616,100	0	70,000,000	0
2006	392,464,500	0	70,000,000	0
2007	413,676,300	35,000,000	105,000,000	378,676,300
2008	479,101,400	40,000,000	145,000,000	439,101,400
Cumulative Totals			640,000,000	1,605,334,600
Difference				965,334,600

Source: Arizona Joint Legislative Budget Committee (actual expenditures).

RECOMMENDATIONS

Four sets of recommendations follow: (1) actions to help balance the budget in the current (and succeeding) fiscal year; (2) proposals to eliminate the long-term structural deficit, to modernize the tax code, to provide a less cyclical revenue stream, and to cause revenue to grow at the same pace as the economy; (3) guidelines for regulating revenue and expenditures from the general fund (option 4 on page 16); and (4) if the third set of recommendations is *not* adopted, then another set of recommendations related to the operation of the budget stabilization fund should be implemented (option 3 on page 14).

Balancing the Fiscal Year 2009 Budget

Given the magnitude of the likely budget deficit in the current fiscal year, that half of the fiscal year already has elapsed, that the “easy” budget fixes already have been implemented, and the time required for most revenue enhancements to take effect, it will not be possible to balance the current fiscal year’s budget entirely by revenue enhancement. Increasing the general sales tax rate is the only option likely to provide a significant influx of revenue during the current fiscal year, but significant spending cuts still will be required to produce a balanced budget. In contrast, the revenue from the higher sales tax rate should go far toward balancing the budget in the next fiscal year.

1. Temporarily Increase the General Sales Tax Rate by One Cent per Dollar

Increasing the rate a full cent on the current distribution base under current economic conditions would generate approximately \$850 million for the state general fund and an additional \$230 million to be distributed to counties and municipalities — over the course of a full year. The amount raised to help balance the current year’s budget deficit will be considerably less given that the increase cannot be implemented until well into the year. Depending on the size of the budget deficit and the difficulty in making spending reductions, a larger rate increase may be desirable. The higher tax rate should be a temporary surcharge that expires between the end of calendar year 2010 and the end of fiscal year 2011, to be replaced by reform of the system (the third or fourth sets of recommendations).

2. Mitigate the Regressive Effects of the Higher Sales Tax Rate by Increasing the Low-Income Tax Credit

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 low-income tax payers by increasing the low-income tax credit. This provision will reduce the net revenue realized by the general fund from increasing the general sales tax rate. The increase in the tax credit should expire at the same time as the sales tax surcharge.

Enhancing Revenue/Reducing Expenditures in the State General Fund

Multiple options exist to remove the structural deficit in the state general fund in the longer term, and to modernize the tax code, provide a less cyclical revenue stream, and cause revenue to grow at the same pace as the economy. Negative effects from revenue enhancement will be limited because of the state’s very low existing tax burden on individuals. The following alternatives are listed in recommended order based on a number of factors, including the likelihood of passage and the degree to which the recommendation would eliminate the structural deficit and achieve the other goals.

1. Reinststitute the State Property Tax, Eliminate the 1-Percent Constitutional Cap on the Residential Property Tax, and Phase Out the Homeowner’s Rebate

The Citizens’ Finance Review Commission recommended each of these actions. Residential property tax burdens in Arizona are low compared to most of the nation and less than in the past. A modest state property tax rate in conjunction with the other actions would raise several hundred million dollars per year, though care needs to be taken so that this proposal does not unduly affect low-income homeowners.

2. Increase the Use of Debt Financing for Capital Outlays (Including School Construction and Renovation)

The CFRC also made this recommendation. Capital investments that will benefit generations of taxpayers generally should be funded through long-term financing. If all school construction and renovations were financed by long-term debt, a few hundred million dollars of spending obligations initially would be removed from the general fund, but this amount would shrink over time as debt payments mounted. An alternative is to finance school construction and renovations from the general fund when a surplus exists. This selective use of bonding would reduce the size of debt repayments and would allow savings to be expended when most needed. (Adoption of this recommendation will not help resolve the budget deficit in the current or following fiscal year since the Legislature already has temporarily implemented bonding for schools.)

3. Broaden the General Sales Tax Base, Lower the Tax Rate, and Increase the Use of Low-Income Tax Credits

Each of these actions was recommended by the CFRC. A net increase of several hundred million dollars to the general fund easily could be realized, though care must be taken that the state’s revenue base is not overly dependent on the general sales tax. An additional benefit of widening the tax base is that revenues from the 0.6 percent earmarked to education would increase by more than \$200 million. The tax base would be broadened by applying the sales tax to certain services and to food to be consumed at home. In addition, some of the other general sales tax exemptions — labeled by the CFRC as ineffective or inexplicable — would be eliminated. Efforts to broaden the sales tax base have met considerable opposition in the past.

4. Eliminate Selected Credits from the Income Tax

The CFRC recommended phasing out the majority of income tax credits. Individual and corporate tax credits currently amount to about \$350 million. In particular, the two school-related credits total close to \$100 million not being placed into the general fund.

5. Widen the Application of, and Raise, User Fees

The CFRC recommended that the use of user fees be examined due to the low collections in Arizona compared to other states. While the amount of revenue enhancement is unclear without further study, it appears that the figure could reach \$375 million even without considering university tuition.

6. Increase the Vehicle License Tax Rate

The vehicle license tax burden in Arizona is low compared to most states and lower than in the past. Without placing the tax rate out of line with other states or with Arizona’s historical rate, \$200 million could be raised.

7. Improve Money Management and Long-Term Planning

Several suggestions to achieve these goals were recommended by the CFRC. Two actions — enhancing revenue enforcement and maximizing interest earnings — could raise substantial, though unknown, amounts of revenue.

8. Increase Federal Funding

The CFRC recommended a more centralized effort to increase federal funding. While the state could gain \$1 billion in federal funds without exceeding the national per capita average, to realize the federal funds, the state would need to increase its own spending. Realistically, it is unclear how much net revenue might be gained through this option.

9. Increase Collections from Selective Sales Taxes

The selective sales taxes should be indexed to inflation as recommended by the CFRC, but this will have little impact on revenue in the short term. The motor vehicle fuel tax and the tax on alcoholic beverages, which are somewhat below the national average, could be increased to the national average, but probably would raise less than \$100 million per year. Further, unless the increase in rates is specified to go into the general fund, most of these additional monies would be placed in other funds.

10. Raise the Personal Income Tax Rate

While the personal income tax burden in Arizona is quite low compared to other states and to the past, calls to increase the tax rate are likely to elicit a strong reaction. While the passage of a “fairness tax” — a form of alternative minimum tax to ensure that filers at very high income levels pay at least their fair share in total income taxes — is more feasible, the revenue enhancement from this source likely would be less than \$100 million per year.

Summary of Revenue Enhancements/Removal of Spending Obligations

	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

Maintaining General Fund Revenue at a Constant Share of Arizona's Economy and Tying Spending Increases to a Formula

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 5 percent.

1. Adopt Revenue Enhancements Such That General Fund Revenue Is Approximately Equal to 4-to-4.5 Percent of Gross State Product

The revenue enhancements that come from the above list will widen the revenue base and bring the tax code into the 21st century, with the result being revenue streams that better match the size of the state's economy. The total amount of revenue enhancement should be targeted to bring total revenue equal to 4-to-4.5 percent of the state's GDP. 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.

2. Control Spending Increases to the Sum of Population Growth, Inflation, and Real Per Capita Economic Growth

A spending rule that consists of the sum of population growth, inflation, and the average per capita real growth of the economy (about 2 percent per year) would allow expenditures to rise on average at the same pace as revenue. Together with a fixed revenue growth rule, this spending rule will allow the state to live within its means while meeting the needs of a growing Arizona.

Maximizing the Budget Stabilization Fund

If the recommendations to maintain general fund revenue at a constant share of Arizona's economy and to tie spending increases to a formula are *not* adopted, then little regarding the functioning of the state general fund has changed even if the structural deficit is eliminated. In this case, improving the operation of the rainy-day fund will be necessary to avoid large budget deficits during economic downturns.

The BSF is designed to serve one very important purpose: to hold general fund revenue relatively constant across the economic cycle. If this purpose were achieved, then the difficult spending decisions and the hardships caused by budget cuts during an economic downturn could be largely avoided.

1. Return the Budget Stabilization Fund Cap to 15 Percent, or Higher

The CFRC recommended that the current limit on the budget stabilization fund be returned to its original 15-percent cap. Since a 15 percent cap will not guarantee adequate funds to balance the budget in all recessions, a higher cap may be prudent.

2. Safeguard the Operation of the Budget Stabilization Fund

The CFRC recommended that the state "take measures to make 'raids' on the fund more difficult." Further, the Legislature has reduced the effectiveness of the BSF through statutory

changes. These issues could be resolved by specifying the operation of the BSF in the Arizona Constitution rather than in statute.

3. Seed the Budget Stabilization Fund With Additional Deposits

Following an economic recession during which the BSF balance drops to a few percent or less of general fund revenue, the BSF will not be able to attain at least a 15 percent balance during the next economic expansion if transfers to the fund are limited to those specified in the formula included in the 1990 legislation. This supplemental seeding also should be specified in the constitution.

4. Create Additional Contingency Funds

A contingency fund under the discretion of the Legislature could be created to resolve unpredictable fluctuations in expenditures. An additional contingency fund could be used to smooth out more predictable cyclical fluctuations in expenditures. Alternatively, the latter function could be added to the design of the BSF by modifying the formula dictating transfers to and from the BSF and raising the cap.

5. 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.