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**Fiscal Alternative Choices Team
(FACT)
Report
Executive Summary Only**

April 2, 2009





Fiscal Alternative Choices Team (FACT) Executive Summary

Backdrop

- We are in the midst of the worst economy and state budget conditions of modern times.
- We have witnessed the rare simultaneous collapse of 4 major markets: housing, financial, equity and commodity markets.
- This is not a typical “V-shaped” recession—it is “U-shaped” and the question is “how long is the bottom of the U”? The Joint Legislative Budget Committee (JLBC) General Fund (GF) revenue forecast does not have the FY 2006 revenue level reached again until after FY 2012, suggesting a 6-Year “U”.
- The deepening financial crisis was evidenced by January’s state GF tax collections, which totaled some 36% less than was collected in January 2007, just two years earlier.
- Arizona’s updated baseline deficit forecast of some \$3.6 billion in FY 2010 represents more than a third of the state’s base General Fund budget.
- By various measurements, Arizona has the distinction of having either the #1 or the #2 (to Nevada) largest budget deficit of the 50 states on a percentage basis.
- To place this deficit in context, on the basis of a 12-month fiscal year, the state would run out of money after 8 months.
- As the new Legislature convened in January, the JLBC presented the “Chairmen’s Budget Options”, which represented very detailed budget reduction options for every agency of state government, designed to eliminate Arizona’s budget deficits entirely through budget cuts.
- In late January, Senate President Robert “Bob” Burns and Speaker of the House Kirk Adams invited the Arizona Board of Regents and state University Presidents to use the resources and talents within the Universities to help develop other ideas for balancing the budget. This report is a response to that request.
- A review of state General Fund revenues and expenditures over the past two decades suggests that Arizona’s deficit is the result of both (1) the deep cyclical recession and (2) the cumulative effect of past legislative actions that both increased spending and decreased taxes beyond a sustainable level.
- At the same time, legislative analysts and university economists are in agreement that the state’s economic recovery will be very gradual and revenues will not re-attain their pre-recession levels again until after FY 2012.



- Meanwhile, the state’s population continues to grow, increasing eligible populations for everything from education, to health care, to the confined population in our prison system.
- Against this backdrop, the FACT review concludes that balancing the budget entirely through budget cuts is not feasible, and a more balanced approach is required.

Summary of FACT Options

The FACT report consists of 9 Short-Term Budget Balancing Options and 7 Long-Term Options to Strengthen State Government Finances

The reality is that there are no truly “good options” for eliminating a deficit of this magnitude. What state policymakers are left with is a range of budget balancing options that have differing impacts on Arizona’s households, Arizona-based businesses, our quality of life, and our future growth prospects. Nonetheless, one reality appears to rise above all others—a deficit of this magnitude cannot be eliminated through budget cuts alone. To do so would have profound impacts on basic government services that would be felt by all Arizonans and would fundamentally transform how Arizona is perceived as a place to live, work and raise a family. Instead, the FACT review suggests a broader and more balanced set of options should be implemented by state policymakers in order to build a bridge that gets us safely to the other side of this great budget divide. The over-leveraging of the U.S. and Arizona economies did not occur over night—it built up over the past decade or more. And, it will not, and should not be fixed in one fiscal year—we will have to pay for past excesses through much more stringent financing of both private and public economies in years ahead. Many of the options described herein are intended to spread the pain over several years, and to impose future discipline in exchange for more immediate relief to the enormous deficits facing the state.

The longer-term options to strengthen state government finances are as important as the short-term options to eliminate the near-term deficits. If we are to avoid future budget showdowns that are even half as bad as current prospects, we need to take steps to better insulate the state budget from the vagaries of the business cycle. As is stated clearly in this report, we are at a crossroads: Either we create a more “defensive” tax structure, that is less subject to the wild swings in Arizona Personal Income; or, we keep our tax structure, which produces revenues very well during the upswings and very poorly during the downturns, and we restructure and dramatically increase Arizona’s Budget Stabilization Fund to more adequately prepare for the next inevitable economic downturn.



Short-Term Budget Balancing Options

The Governor Should Optimize the use of Federal Stimulus Monies from the ARRA to Reduce Projected Deficits

The State of Arizona is eligible to receive over \$4 billion of monies under the American Recovery and Reinvestment Act (ARRA), with some \$2.3 billion of these dollars in the form of additional Title 19 (Medicaid) monies and State Fiscal Stabilization Funds (SFSF) that can be used in FY 2009 and FY 2010 to offset General Fund appropriations in a manner that will help balance the state budget. Thus, some 40% of deficits in the two years can be managed in this way. However, it will leave a significant funding gap in FY 2011 and FY 2012, prior to the projected resumption of more normal state revenue growth.

Seek Voter Approval of Temporary Tax Increases

The Legislature may wish to let the voters decide whether state taxes should be increased to help bridge the extraordinary deficits facing the state over the next few years. If so, the FACT group suggests that the increase reflect the state's requirements for the next 3-4 fiscal years, and that it include some element of structural tax reform and possibly future tax reduction, as described below.

Seek Voter Approval for Relief from Certain Voter-Protected Spending Requirements Under Strict Criteria

The Legislature may wish to ask voters to lift certain Voter Protected spending requirements. If so, the FACT group suggests placing very strict criteria as to when this might be permitted, so the voters will know its under very unusual and dire budgetary circumstances like the present.

Is there a “Non-Proposition 108” Temporary Tax Increase Option? The answer may be “yes”, in the form of a bill that raises revenues for four fiscal years and cuts taxes permanently thereafter.

While most of the discussion regarding a temporary tax increase has centered on referring a temporary tax increase to the voters of Arizona at a special election, the State Legislature could enact a temporary tax increase and possibly do so without a Prop 108 two-thirds majority. Under Section 22 of Article IX of the Arizona Constitution a two-thirds majority is required for a bill that increases state revenues, as defined in Section 22. Given that our need is for a short-term infusion of revenues to help bridge the gap over a four fiscal year period, what if a bill provided for additional revenues for a four year period followed by a permanent tax cut beginning in the 5th year and thereafter? The FACT report contains such a simulation for both the sales tax and income tax and offers a structured tax plan for legislation that would amount to a



“net tax cutting bill”. There is not a lot of legal guidance in this regard, but it is certainly worth debating the merits of such an approach whereby a simple majority of the Legislature could establish a reasonable approach to balancing the budget that smoothes the collections of revenue across the business cycle.

Sales Tax Increase and Reform—If revenues are to be raised through a rate increase in the short-run, it would be preferable in the long-run to broaden the base of the tax and lower rates.

Arizona has one of the highest combined state and local sales tax burdens in the nation. While polls consistently show public support for a tax increase to be highest if the chosen tax is the sales tax, we nonetheless run the risk of having a tax rate that is uneconomic for a number of reasons (competition, tax avoidance, internet and mail order sales, etc.). This concern can be addressed if Arizona takes steps to broaden the base of the sales tax (it is actually a Transaction Privilege Tax (TPT), to be paid by the business making the sale) and uses the additional revenue to lower the sales tax rate. This report describes a number of potential areas of base broadening and calculates how the rate might be lowered. A significant tax reform measure such as this takes time to implement. In the short run, a sales tax rate increase could be presented to the voters, or could be enacted by the Legislature in a structured manner that both raises taxes initially and cuts taxes permanently thereafter.

Broadening the base of the sales tax (TPT) is advisable for a number of reasons, but certainly to help create a more stable and less volatile sales tax base is one of the most important reasons given recent events.

Income Tax Increase and Simplification—while the individual income tax is not as frequently mentioned as the sales tax as the source for a temporary tax increase, it should not be overlooked, particularly if coupled with long-term simplification and further tax reduction.

Of the 41 states that levy an individual income tax on wages, Arizona ranks 39th. The state income tax is deductible for those taxpayers who itemize on their federal income tax returns, meaning that an average of 20 percent, and as much as 40 percent of the tax increase would be offset by a decrease in federal taxes.

In addition to a temporary increase in personal income tax rates, there is an opportunity to simplify Arizona’s income tax law by going to either a flat tax or a modified flat tax. The advantages of such an approach are explained in this report, including more stability and predictability in future income tax collections, a plus given recent developments. A total of 5 alternative income tax structures are examined, all aimed at income tax simplification.

The challenge is that immediate conversion to a flat-income tax would lead to some serious “vertical equity” concerns, as the highest income taxpayers would see a



significant tax cut while middle to upper-middle income taxpayers would see a tax increase. The implications of the 5 strategies are all evaluated in the context of widely held attributes of a good revenue system.

A move to simplify Arizona's individual income tax could be coupled with a structured increase and decrease in taxes to help solve Arizona's state budget deficits.

Delay Scheduled Business Property Tax Cuts until after FY 2012—it is acknowledged that Arizona's business property taxes are too high and are an impediment to economic development. However, the State cannot afford to implement these cuts at this time. They represent a relatively straightforward and easy means of helping to balance the budget.

Legislation to reduce the assessment ratio on Class 1 property (commercial and industrial) was enacted in 2005 and was further accelerated in 2007, to reach 20% in 2011. Legislation also suspended for FY 2007 through FY 2009 the so-called Statewide Equalization Tax (SET) on property that is used to help fund K-12 Basic State Aid.

The JLBC baseline budget assumes the Equalization Tax levy is further suspended or eliminated in FY 2010 and beyond. The combination of the further decrease in the Class 1 assessment ratio and elimination of the Statewide Equalization Rate increases the State's cost of K-12 Basic State Aid by over \$300 million. Given the size of our deficits and the fact that it would take legislation to extend the SET tax break, should make this an easy decision for policymakers struggling to balance the budget. By placing Class 1 property back on the original schedule for being reduced to 20% by 2015, and by making the SET elimination permanent beginning in 2012, the budget deficit can be reduced by roughly \$300 million over each of the next three fiscal years.

Making elimination of the SET permanent in 2012 could be made part of an overall tax package of structured increases and decreases in taxes, and might further solidify such a bill as a non-Prop 108 bill that may be enacted through a majority vote of the Legislature.

Retain a Significant Portion of Vehicle License Tax (VLT) Revenues in the General Fund as was once the Practice

The suggestion here is to deposit a significant portion of the Vehicle License Tax (VLT) revenues into the General Fund, as was once the case. These are not highway related revenues that are protected by the Arizona Constitution. Rather, these are personal property taxes that are levied based upon the value of the vehicle regardless of whether they ever travel one mile on public roads. According to the JLBC Tax Handbook, in FY 2008 the net VLT collections were \$859 million, of which only \$2.3 million was deposited in the state General Fund.



Currently, over three-quarters of VLT revenues are forwarded to local governments and another twenty percent are deposited into the State Highway Fund. Because the Arizona Department of Transportation (ADOT) does not receive funding through the state's General Fund, they are relatively immune from the state's current budget crisis. This option would not only assist in eliminating the General Fund deficit, it would provide some equity by having the transportation function of government participate in resolving the State's budget deficits.

To the extent that the resulting shortfalls in transportation funding are deemed unacceptable, state policymakers could consider raising the State's motor fuel taxes, which are below average as compared to other states. The Legislature could also consider extending the State's sales tax (TPT) to include the sale of motor fuels at retail, as do many states.

Sale-Leaseback Programs Can Provide a Short-Term Boost to State Revenues

There are many companies willing to buy state lands or buildings in exchange for an assured stream of lease payments over 10 to 30 years. In effect, state and local governments would be receiving payment for an asset in exchange for the state/local government entering into a binding long-term obligation. For severely stressed state and local governments like Arizona and its many local jurisdictions, a sale-leaseback program is a reasonable alternative to a tax increase or other means of raising revenues, as it does defer the spending (or taxing) obligation to a future period when, hopefully, the state economy and fortunes of households and businesses alike are in better shape.

Additional "Rollover" Opportunities Exist, but Must be Measured Against Impact on State Cash-Flows

The Legislature has already implemented a "double-rollover" payment for K-12 State Aid. The potential exists to "rollover" June payments for Higher Education and AHCCCS medical providers to achieve similar one-time budgetary savings of perhaps \$160 million. However, care must be taken to measure any such bookkeeping changes in terms of their impact on the State Treasury and cash-flows.

Resist Cutting Positions (FTE's) in Revenue-Producing Agencies such as ADOR and the State Land Department

The Arizona Department of Revenue (ADOR) and the State Land Department (SLD) are more critical than ever when revenues are slumping. During the recent mid-FY 2009 budget cuts, the ADOR was reportedly cut 200 positions. The SLD was also subject to budget cuts to save general fund dollars. Meanwhile, the Governor has announced a spring "Tax Amnesty" program designed to provide a one-time revenue gain from delinquent taxpayers. The point is that the Legislature should be adding monies to the



ADOR, not cutting their budget, because we need the ADOR to aggressively seek to collect all monies owed to the state.

The Legislature may wish to have revenue-generating agencies become self supporting, and have their operating budgets derived from a percentage of the revenue they generate, of course, all the while having their budgets subject to annual legislative appropriation.

Long-Term Options to Improve the State General Fund

The members of FACT have been active participants in analyzing, forecasting and measuring the economy over the past two to three decades. In fact, the 9 members of FACT have cumulatively been engaged in such activities for over 200 years. We mention this because we have seen many commissions come and go through the years, and their learned recommendations gather dust on so many shelves throughout the halls of state government and academia.

This is a trend we would like to see reversed. While we are offering a number of options to help balance the state budget over the next three fiscal years, it is more important that state policymakers establish a more predictable and stable path for the delivery of vital state and local government services over the decades ahead.

In particular, the members of FACT believe Arizona is at the cross roads of a vital decision: Either we create a more stable, “defensive-oriented” tax structure (meaning, it is less influenced by Arizona’s hyper-growth as well as Arizona’s deep recessions) or we accept our tax structure for what it is, and establish America’s most aggressive and well-funded Budget Stabilization Fund (BSF).

Create a More “Defensive” State Tax Structure

Creating a more defensive tax structure means lessening our reliance on taxes that swing hyperactively based upon the economy’s performance. As shown in the graph below Arizona’s sales and income taxes have amplitude of annual change that is 2-3 times as great as the annual change in state personal income. Given that sales and income taxes account for over 90% of state General Fund revenues, this means that state revenues will grow rapidly during the states’ strongest growth years, but will contract disproportionately during the state’s recession years.



**ANNUAL PERCENT CHANGE IN REAL PER CAPITA DOLLARS,
FISCAL YEARS 1989 THROUGH 2009, PERSONAL INCOME AND
ARIZONA STATE GOVERNMENT GENERAL FUND REVENUE**



This tendency is the result of over reliance on these two volatile revenue sources, coupled with the fact that the tax bases for these two major tax sources are heavily dependent upon sources that grow dramatically in the up years and decline just as dramatically during economic downturns. For example, the sales tax is largely based on the sale of goods and is heavily influenced by the sale of durable goods (autos, appliances) and new home construction (contracting tax), which are the first categories of consumer spending to be sharply curtailed during a recession. Similarly, the income tax is heavily influenced by the sharp fluctuations of capital gains income driven both by real estate and financial market fluctuations.

Creating a more “defensive” tax structure means re-examining past decisions to eliminate General Fund revenues from other more stable tax sources. If you go back three decades, you find that the sales tax and income taxes comprised about 66 percent of state General Fund tax revenues, not 90 percent+ like today. Creating a “defensive” sales tax structure means broadening the sales tax base (while lowering the tax rate) to include expenditure categories that are more stable across the business cycle. Through the years, whether by legislative action or voter initiative, broad areas of commerce that were previously subject to the tax were eliminated. For example, food for consumption at home was eliminated by voter approval in July 1980 and the tax on commercial leases was eliminated in July 1997. As detailed elsewhere in this report,



according to the Arizona Department of Revenue (ADOR) publication The Revenue Impact of Arizona's Tax Expenditures FY 2007/08, the loss of revenue associated with these two decisions is over \$1 billion.

Were these categories to be taxed once again, the sales tax (TPT) rate could be decreased by approximately one percentage point. With respect to the income tax, creating a more defensive tax structure means considering an approach to income tax simplification that makes the tax less reliant on volatile income streams and reduces the entire range of deductions, credits and tax brackets.

A more stable revenue system for the General Fund also would include a broader range of revenue sources, as in the past. This report suggests returning vehicle license tax revenues to the General Fund and reinstating a statewide property tax (to fund school construction).

Modify, Expand and Strengthen the State's Budget Stabilization Fund

Knowing that Arizona has one of the nation's most volatile economies and, hence, one of the most volatile governmental revenue streams, in 1990 the Legislature enacted one of the nation's first Budget Stabilization Funds (BSF). It remains one of the few that is governed by a formula designed to objectively determine the size of both deposits into the Fund and withdrawals from the Fund during a recession. The JLBC analysis that served as the basis for the design of the fund and its formula called for a maximum fund size equal to 15% of the prior year's General Fund revenue. Unfortunately, the Legislature chose to reduce the maximum fund balance from 15% to 7%, because such a large fund balance requirement was restricting their ability to increase state spending or cut state taxes. Yet, that is precisely why the BSF should have been funded at a minimum of 15%.

Deposits into a so-called "rainy day fund" have a twin benefit—every dollar that is deposited into the BSF is a dollar that is not available to be spent or to be cut, in the case of taxes. So, for a state that sees its revenues soar in the strongest economic years (such as FY 2005 to FY 2007), deposits into the BSF puts \$1 into the Fund and takes \$1 away that might create a permanent obligation to spend or a permanent loss of revenue. In other words, every \$1 that is deposited into the BSF provides a \$2 budgetary dividend.

If Arizona chooses to not create a more "defensive" tax structure, we must take steps to strengthen our BSF, including raising our maximum BSF balance to 15% of state revenues. Even with a more stable revenue system, a 7 percent cap on the BSF is not adequate to ensure the availability of adequate funds to transfer into the General Fund during a period of economic decline.

This report contains a number of suggestions for strengthening the BSF and better managing the state's finances in the future.



Match Tax Cuts with Spending Cuts and Spending Increases with Tax Increases on a “Business Cycle Neutral Basis”

As documented in the appendix to this report, the current budgetary deficit consists of a “cyclical” component related to the current deep economic recession, and a “structural” component related to past decisions to both cut taxes and increase spending that were funded on the basis of the “froth” of an economic boom as opposed to any sustainable shift in the state’s fortunes. In the 1990’s the emphasis was on using the surpluses of the mid-90’s to fund tax cuts, most notably, income tax cuts. In the late 90’s, the emphasis shifted to cutting business taxes and assuming the costs of the “Students FIRST” school construction program without a dedicated funding source.

In the mid-2000’s, the emphasis was on making up for the lack of spending growth in the early part of the decade due to the effects of “9-11”. The Legislature brokered a deal that increased spending in exchange for further cuts in individual income and business property taxes. Again, both of these initiatives, while they may have been worthy goals, were accomplished on the strength of unusually sharp and ultimately unsustainable revenue growth from FY 2005 to FY 2007.

In order to get off of this “boom-bust cycle” it is recommended that future legislatures make sure that tax cuts are matched by spending cuts and that any desired spending increases are matched by tax increases.

Create a Dedicated Funding Stream for Students FIRST and Rely on Debt Financing when State Finances are Constrained by Recession

Since enactment of Students FIRST a decade ago, the Legislature has debated the wisdom of debt financing for school construction. Certain members have argued to fund school construction on a “pay-as-you-go” basis, while others would always issue revenue bonds for school construction to free up state general fund dollars for ongoing operational spending.

Elsewhere in this report, we suggest the Legislature consider creating a permanent dedicated funding stream for Students FIRST. If a dedicated funding stream is enacted, the argument of “pay-as-you-go” versus debt financing is rendered moot. Within a given revenue stream, the School Facilities Board should be given the authority to utilize the financing approach that is most beneficial given a variety of variables including student growth (need), inflation, interest rates, and projected cash flows.



Further Privatization of State/Local Services

Arizona already “privatizes” more governmental functions than most states; however, there may be more opportunities for delivering governmental services through private companies. Privatization can sometimes achieve greater efficiencies and cost savings, and may shift business cycle risk away from government to the private sector. It is recommended that the Legislature examine additional state/local programs worthy of privatization or “public-private partnerships” for the delivery of governmental services that lessen the reliance on state general funds.