

Riding the Fiscal Roller Coaster:

Government Revenue in Arizona



95th Arizona Town Hall

November 1-4, 2009 | Grand Canyon, Arizona



Background report prepared by the
L. William Seidman Research Institute,
W. P. Carey School of Business,
Arizona State University





October 2009

We thank you for making the commitment to participate in the 95th Arizona Town Hall to be held at the Grand Canyon on November 1-4, 2009. You will be discussing and developing consensus with fellow Arizonans on Arizona's revenue system.

An essential element to the success of these consensus-driven discussions is the background report that is provided to all participants before the Town Hall convenes. As they have so often done for past Arizona Town Halls, Arizona State University has prepared a detailed and informative report that will provide a unique and unparalleled resource for your Town Hall discussions.

Very special thanks go to Dennis Hoffman and Tom Rex who spearheaded this effort and served as contributing authors, marshaled top talent to write individual chapters, and ensured all deadlines were met. For sharing their wealth of knowledge and professional talents, our thanks go to the many authors who contributed to the report.

The 95th Town Hall could not occur without the financial assistance of our generous sponsors, which include Speaker Sponsor Greater Phoenix Leadership and Associate Sponsors Mohave County, The Virginia G. Piper Charitable Trust, and Jennings Strouss.

When the 95th Town Hall ends, ASU's background report will be combined with the recommendations from the Town Hall into a final report. This final report will be widely available to the public on the Town Hall's website and will be widely distributed and promoted throughout Arizona. The work of the Town Hall participants and the final report will help to create solutions that will optimize Arizona's revenue system.

Sincerely,

A handwritten signature in black ink, appearing to read 'Bruce Dusenberry', is written over a large, stylized circular flourish.

Bruce Dusenberry
Board Chair, Arizona Town Hall

Ninety-Fifth Arizona Town Hall
November 1-4, 2009

**Riding the Fiscal Roller Coaster:
Government Revenue in Arizona**

September 11, 2009

**Background Report Prepared by Arizona State University's
W. P. Carey School of Business**

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Note Regarding Data:

Two sources of data are used widely throughout this document, as discussed in Appendix 2. Summary data on the state government general fund reported by the Arizona Joint Legislative Budget Committee (JLBC) for fiscal year 2009, which ended on June 30, have been incorporated into this report. However, some of the more detailed data for state government for fiscal year 2009 had not yet been published by the JLBC when this report was sent to the printer.

For state and local governments combined, the U.S. Census Bureau provides annual data that can be used to compare states. In years ending in '2' and '7' these data are based on a census of governments. In other years, the Census Bureau collects data from state governments and a sample of local governments. The release of the fiscal year 2007 data has been postponed by the Census Bureau, precluding the analysis of those data in this report. Assuming the Census Bureau data are not further delayed, a summary of these data will be produced as a separate document for release at or before the Arizona Town Hall meets at the Grand Canyon.

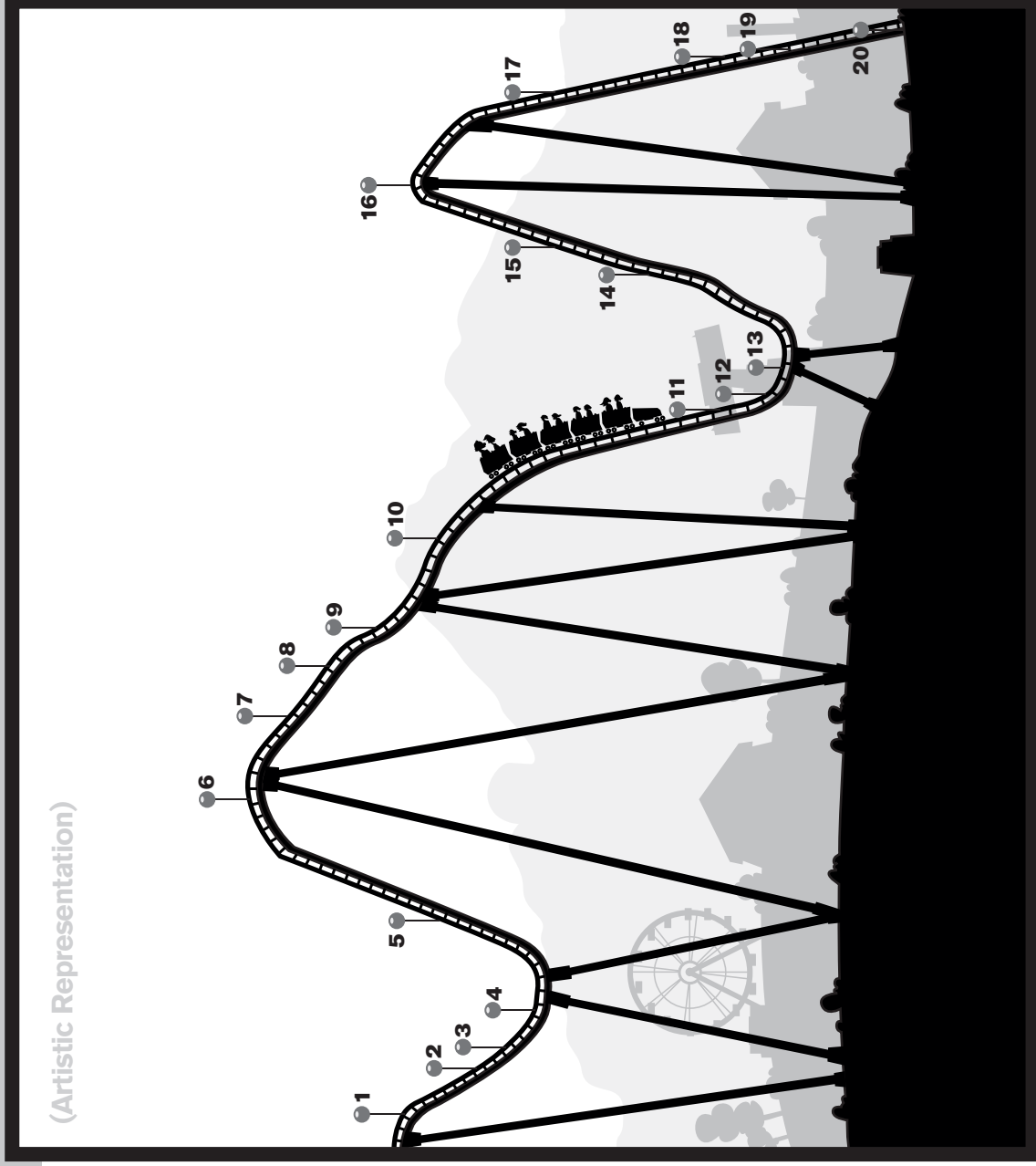
The latest Census Bureau data shown in this report are for fiscal year 2006. While these data are based on a sample of local governments, the time series of historical data does not reveal obvious inconsistencies between the census data produced every five years and the sample data in the intervening years. However, the Arizona Tax Research Association has identified certain Arizona state government revenues that appear to have been omitted from the 2006 data. Thus, Arizona governments probably collected more revenue than reported, affecting the comparison over time as well as to other states.

The Census Bureau has a massive task compiling these data from thousands of governments across the country. State and local governments do not use a consistent accounting system. Some of the accounting systems are quite complex. The Census Bureau converts these many accounting systems to one consistent system so that data can be fairly compared across states. Further, the Census Bureau depends upon the accurate reporting of data by state and local governments.

Thus, errors in the Census Bureau data are inevitable. Errors in the data reported for Arizona are not unique. Indeed, the Tax Foundation, for instance, discovered a significant error in the reporting of revenue data for Indiana. If all of the errors and inconsistencies across the states and years were discovered and corrected, it is not clear if the relative results for Arizona would be significantly different from those reported by the Census Bureau. For example, other studies of the tax burden agree with the conclusion reached from the Census Bureau data: the tax burden in Arizona is low compared to other states and has declined over time.

Much of the analysis in this report is unaffected by any problems that may exist in the Census Bureau data, since it is based upon the record of the revenue streams available to support the state's general fund spending initiatives from fiscal years 1971 through 2009. These data come from actual general fund accounts as reported by the JLBC, not samples, surveys, or census reports. These data clearly reveal that general fund revenues have not kept pace with Arizona's economic growth during the last 15 years.

Arizona State Government General Fund Ongoing Revenue Per \$1,000 of Personal Income, 1988 to 2009



- | | |
|----|---------------------------|
| 1 | Real Estate Crash |
| 2 | Deficit |
| 3 | Rainy-Day Fund Created |
| 4 | 1990-91 Recession |
| 5 | Economic Recovery |
| 6 | Tax Cuts Begin |
| 7 | Rainy-Day Fund Modified |
| 8 | More Tax Cuts |
| 9 | Stock Market Boom |
| 10 | More Tax Cuts |
| 11 | Stock Market Crash |
| 12 | 2001 Recession |
| 13 | Large Deficit |
| 14 | Economic Recovery |
| 15 | Real Estate Boom |
| 16 | Another Round of Tax Cuts |
| 17 | Real Estate Crash |
| 18 | Recession Begins in 2007 |
| 19 | Revenue Plunges |
| 20 | Record-Setting Deficit |

Chapter 1

INTRODUCTION

Dennis L. Hoffman

Arizona State University, L. William Seidman Research Institute

Government revenue—primarily taxes—always is a “hot” issue. This is especially so now, given the budgetary problems faced by state government and most local governments in Arizona during the past two years. While more severe than in the past, the budget shortfalls are not new: imbalances between revenues and expenditures were a significant issue from 2001 through 2003, and in fact, during each of the previous economic recessions.

Public finance—what government is or should be doing and how to pay for those activities—is an extremely broad topic. What government *should be* doing—a highly controversial subject—is NOT addressed in this report, though the various economic reasons for the existence of government are presented briefly in Chapter 2. That chapter also touches on what government *is* doing by summarizing the expenditures of public monies in Arizona.

This background report focuses on Arizona’s revenue system—the means of paying for government activities. Answering the question of what government *should be* doing is NOT a necessary precursor to *designing* an optimal revenue system. The primary purpose of the report is to inform Arizona Town Hall participants about the existing revenue system so they can determine whether reform of the revenue system is advisable, and if so, to consider the design of a better system—without determining how much revenue to collect.

Previous efforts to analyze the revenue system have been made over the past 20 years, but few of the recommendations made by these study groups have been implemented. Thus, this background report takes the unique additional step of attempting to determine why these prior efforts were not successful. This assessment was made primarily by interviewing long-time observers of Arizona’s political process. As revealed by the compendium of opinions of individuals who have been deeply involved in reform efforts (from across the political spectrum) in Chapters 18 and 19, passing any type of comprehensive revenue reform in the near term may be extremely difficult. In order to successfully *implement* a well-functioning revenue system, it may indeed be necessary to first address the question of what government *should do*.

THEMES FROM THIS REPORT

A particular focus of this report is the state government general fund, which has experienced the most severe imbalances between revenues and expenditures of any of the numerous state and local government funds in Arizona. However, the state’s general fund cannot be examined independently of the finances of the hundreds of local governments in Arizona, of the other funds used by state government, or of the revenues received from the federal government. Government revenue is a *system*. Like any system, examining the parts

independently and implementing changes in a piecemeal fashion is likely to result in unintended consequences and a suboptimal system.

In addition to considering government revenue as a *system*, other themes emerge from this report. The first is apparent in the report's title. Government revenue in Arizona is highly *cyclical*, going up and down with the economic cycle. While cyclicity is not the only revenue system issue, the budget deficits the state has encountered in each of the last several economic recessions have received the most attention and have been the primary prompt to examine the revenue system. The shape of the roller coaster on the cover, and repeated on the chart that immediately precedes this chapter, represents revenue collected for the state's general fund adjusted for population growth, inflation, and economic growth. However, the revenue data used for the data points on the left side of the chart were adjusted to remove the effects of the tax increases passed in the late 1980s and very early 1990s.

Much of the revenue cyclicity is inherent to the state's highly cyclical economy, but part is due to the design of the revenue system (see Chapter 10). Changes to the system since the early 1990s have increased the cyclicity of revenues. Yet demand for most government services is not cyclical, and the demand for some services (such as unemployment insurance claims) is countercyclical—rising during recessions as revenues fall.

Like most states, Arizona's revenue system was designed decades ago, though a large number of piecemeal changes to the system have since occurred. The sales tax in particular has not been modified to keep pace with changes over time in consumer expenditures. Since the revenue system has not changed as substantially as the evolution of the economy, government revenues are not expanding at the pace of the economy.

Relative to other states, Arizona's revenue system relies more heavily on taxes than on user fees. Yet the state has a narrow tax base. In particular, the state's general fund is highly dependent on only two taxes that are especially cyclical: the individual and corporate income tax and the general sales tax. Including local sales taxes as well as the statewide tax, the general sales tax rate in Arizona is high.

The cyclical misalignment between public revenues and expenditures could be reduced, but not eliminated, as discussed in Chapters 15 and 16. Thus, fiscal experts indicate that a mechanism to pay for education, public safety, and other programs when revenues temporarily fall during an economic downturn becomes a necessary component of a well-functioning revenue system. The state's *rainy-day fund* (the budget stabilization fund) is mentioned in several chapters and is the topic of Chapter 17. As currently designed, the rainy-day fund in each of the last two recessions has been depleted long before revenues have recovered.

The cyclical nature of government revenues is not the sole reason for the state's recent budget difficulties. A *structural deficit* (discussed beginning on the next page) also exists—revenue is insufficient on average over the economic cycle to pay for the state's expenditures. To repeat, determining the appropriate level of revenues and expenditures (what government should be doing) is *not* the purpose of this report. Indeed, the optimal

structure of the revenue system is independent of the amount of revenue that needs to be collected. But adoption of an ideal revenue system while leaving a structural imbalance in place will not result in a well-functioning *fiscal system*. (A fiscal system includes not only the revenue system but also expenditures and debt.)

Taxes, as the largest component of state and local government revenue, are discussed throughout this report. The overall tax burden in Arizona is lower than in most states, and is lower than it was in the past, as discussed in Chapter 9. This low overall burden is the result of a very low tax burden for individuals and a moderate tax burden for businesses in general.

Small unincorporated businesses have a relatively low tax burden. However, the taxes paid by large corporations are relatively high. The differential in tax burden between small and large businesses results from two factors. First, business property taxes are moderate for properties with a low valuation but quite high for large businesses, especially those with substantial equipment (those subject to the business personal property tax). Second, unincorporated businesses file under the individual income tax code, which results in a lesser relative tax burden than for corporations filing under the corporate income tax code. Thus, businesses—particularly large corporations—subsidize other taxpayers. The balance between individual and business taxes is an important consideration in creating a well-functioning revenue system (as discussed in Chapter 13).

The driving forces for revenue reform include the severe cyclicity of the existing system (more volatile than in the past and compared to other states), the failure of the existing system to generate revenues that grow at the pace of the economy, and the existing system's negative impacts on economic competitiveness due to relatively high business taxes. These are relevant factors regardless of the total amount of revenue to be collected.

Improving the revenue system in each of these regards would raise the rating of the system against the guiding principles (discussed in Chapter 11) of stability, responsiveness, predictability, and competitiveness. Yet the existing system also could be improved on most of the other revenue system guiding principles, including efficiency (the existing system has a narrow tax base with high tax rates), neutrality and horizontal equity (the system has multiple tax credits and exemptions), vertical equity (the current system is highly reliant on regressive taxes), and simplicity (the property tax and sales tax codes in particular are unusually complex).

Structural Deficit

Many states have a structural deficit, though Arizona appears to have one of disproportionately large size. Structural deficits have two causes:

- Revenues chronically not growing in tandem with economic growth and the cost of government. This results from the failure to modernize revenue systems, which largely were created in the 1930s, to reflect changes in the economy in recent decades.
- Permanent changes being made only to revenues or only to expenditures. During periods of strong revenue growth that temporarily occur during economic expansions, states have a tendency to permanently reduce taxes without reducing expenditures

and/or to create permanent new spending initiatives without raising additional revenue. When economic growth inevitably slows, revenues drop and the underlying structural deficit becomes obvious.

Both factors contribute to Arizona's structural deficit. In particular, revenues to the state's general fund have been greatly reduced since the early 1990s due to a series of tax law changes that have reduced tax rates, eliminated entirely the contribution of some taxes to the general fund, and increased the number of tax credits and tax exemptions. The tax changes were passed when budget surpluses existed and were not equally matched by spending reductions. In addition, spending requirements were added to the general fund, most notably by shifting most of the expenditures for school construction into the general fund without enhancing revenue to cover these additional expenditures.

The structural budget deficit of the Arizona state government general fund is not examined in detail in any of the other chapters of this report because of the focus of the report on revenues, rather than on the balance between revenues and expenditures. Yet, the structural deficit along with the cyclical deficit is the cause of the imbalance in the general fund that has so dominated the news since 2008 and factored into the choice of this Arizona Town Hall topic.

Linking revenues and expenditures is a key guiding principle of a *fiscal* system (as discussed briefly in Chapter 11). The existing structural imbalance between revenues and expenditures has been cited as the main cause of low ratings of Arizona's fiscal system (see Chapter 14). As defined by these independent and out-of-state experts, a highly rated fiscal system cannot be achieved in Arizona without resolving the structural deficit and reducing the magnitude of the cyclicity of the revenue collections.

The "Fiscal 2000" report from 1989 cited a structural deficit as one of the state's largest problems.¹ That deficit largely was the result of tax cuts implemented from 1979 through 1981 that were not accompanied by commensurate reductions in spending. A combination of spending reductions and revenue increases in 1989 and 1990 largely resolved that structural deficit.

Three factors created a new structural deficit in the state's general fund beginning in the early 1990s:

- The failure of the existing revenue system to produce revenues that keep pace with economic growth.
- New spending obligations from the general fund, such as school construction and the expansion of Medicaid requirements, that were not accompanied by new or expanded revenue sources.
- A long series of tax reductions that were not accompanied by a commensurate amount of spending reductions.

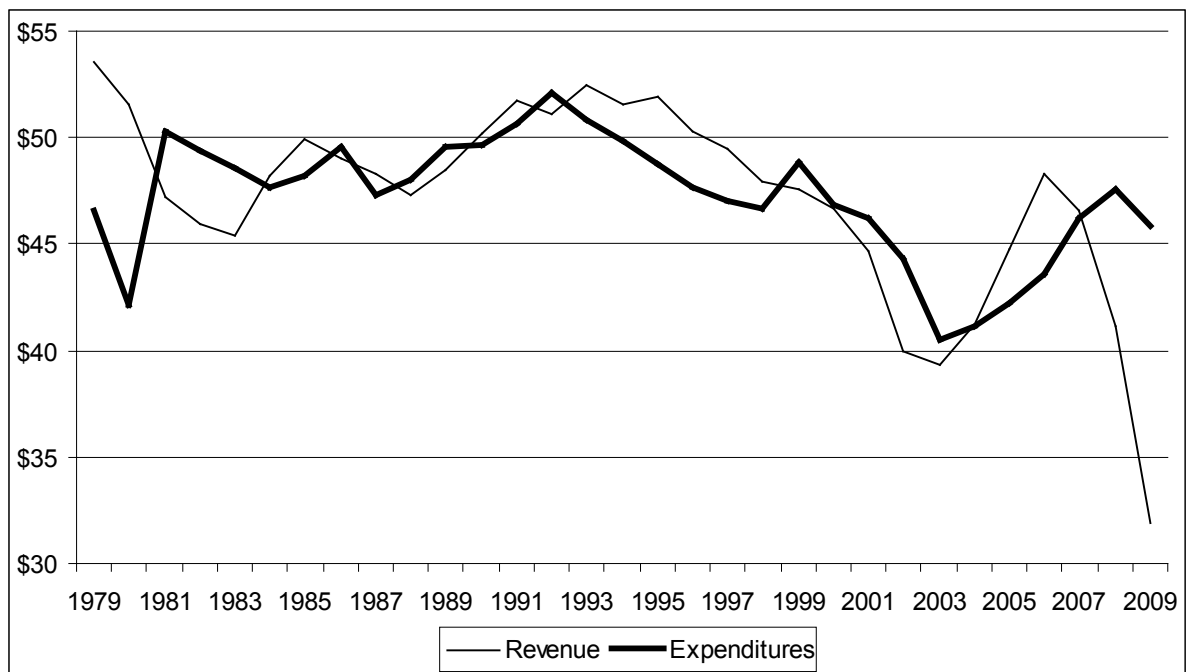
The tax reductions have been the largest cause of the structural deficit. As presented in Chapter 7, estimates of the impact of the tax reductions since 1993 cumulate to \$1.4 billion in nominal terms and \$2.6 billion after adjusting for inflation and population growth. This

revenue decline is clearly seen in the revenue line in Figure 1.1, though the cyclical nature of the revenue collected distorts the exact impact of the tax reductions. As seen by the expenditure line in the chart, spending per \$1,000 of personal income has fallen over the same time period, but not to the same extent as revenues.

Prior to the current economic cycle that began in fiscal year 2002, ongoing revenue to the general fund (excluding any carry-forward balance from the prior year and transfers from other funds) averaged close to \$50 per \$1,000 of personal income. Expenditures per \$1,000 of personal income averaged more than \$48. In the current 2002-09 cycle, the average revenue figure has dropped 16%, while the expenditure average is down 9%. The constitutional balanced-budget requirement has been met by transferring monies to the general fund from other funds.

Though ongoing revenue per \$1,000 of personal income averaged more than \$41 in the 2002-09 economic cycle, the figure plunged in fiscal year 2009 to less than \$32. A huge difference between revenues and expenditures is seen in Figure 1.1 for fiscal year 2009. Revenues were \$3 billion (30%) short of the initial appropriation and \$2.5 billion less than the revised appropriation. This follows a shortfall of \$1.4 billion in fiscal year 2008 between revenues and the revised appropriation.

Figure 1.1
Ongoing Revenues and Expenditures Per \$1,000 of Personal Income,
Arizona State Government General Fund, Fiscal Years 1979 Through 2009



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

The budget in 2008 was balanced primarily by transferring monies into the general fund from the budget stabilization fund and a host of other state funds. In 2009, little was left in the budget stabilization fund, but federal stimulus monies and further fund transfers were among the means used to produce a balanced budget. It is difficult to determine just how much of the deficit in these two years was due to the cyclical versus structural components, but it is safe to conclude that both factors have contributed significantly to the recent imbalances in the state government general fund.

PREVIEW OF THIS REPORT

The 18 chapters that follow this introductory chapter can be divided into four groups. Chapters 2 through 4 provide an introduction to public finance. The existing situation in Arizona—legal restrictions to the collection of revenue, the process of collecting revenue, and empirical data regarding the amount of revenue collected—is the topic of chapters 5 through 10. Chapters 11 through 17 examine topics related to what an ideal revenue structure in Arizona might look like. Finally, the last two chapters look at the *process* of making changes to the existing revenue system.

Some topics are addressed in more than one chapter. This provides an indication both of the cross-cutting nature of the topic and of its significance.

Part I: Introduction to Public Finance

Chapter 2 is the only chapter to address government expenditures. It provides the economic rationale for the existence of government, and explains that taxes and user fees are the price paid for public services, such as police protection.

Chapter 3 provides a primer on state and local government revenue systems from a national perspective. Some key differences in Arizona’s revenue system relative to the national norm are introduced in this chapter, including the complexity of Arizona’s property and sales taxes. Some of these topics are explored in more detail in the chapters in Part II.

Chapter 4 introduces the relationships between taxes and economic growth. It builds on Chapter 2 in linking public services and economic health. Conceptually and empirically, it explains the lack of a significant relationship between tax increases and reductions in Arizona and subsequent changes in economic growth.

Part II: The Existing Revenue System in Arizona

Chapter 5 summarizes sections of the Arizona Constitution that apply to the powers given to, and the limits placed upon, state and local governments to raise taxes and other revenues. The constitutional limitations on expenditures and debt indirectly act as limits on revenues.

Chapter 6 provides a brief background on the budget process and the revenue collection process used by state government. **Chapter 7** is an extension of chapter 6 that examines empirically the amount of revenue collected by state government by source. It includes a discussion of the changes to the tax code that have been made over the last 30 years, particularly the tax cuts passed since the early 1990s.

Chapter 8 is the local government counterpart to Chapter 6. State law places a number of restrictions on the operations of local government fiscal systems. **Chapter 9** is the local government counterpart to Chapter 7, but largely examines the combined state and local government revenue system in Arizona in relation to the national norm. Tax burden studies also are discussed.

Chapter 10 focuses on the cyclicity implied in the title of this Arizona Town Hall report. It first looks at the unusual cyclicity of the Arizona economy and then addresses the high cyclicity of the state's revenue system. This cyclicity is contrasted to the noncyclical, and in some cases countercyclical, demands on the public sector.

Part III: Designing a Well-Functioning Revenue System in Arizona

Chapter 11 reviews the national literature regarding the guiding principles behind a revenue system. Briefly, it qualitatively evaluates the state's revenue system.

Chapter 12 summarizes the recommendations of the Citizens Finance Review Commission, which was the most recent effort (in 2003) at comprehensive revenue reform in the state.

Chapter 13 examines the rationale for taxing businesses. Across the nation, businesses pay more taxes than the cost of the public services they consume. Business taxes in Arizona are compared to those in other states.

Chapter 14 compares Arizona's revenue system to that of other states, in part an extension of the analysis in Chapter 9. It presents a more detailed analysis of how Arizona's revenue system compares to the highly ranked revenue system in neighboring Utah.

Chapter 15 incorporates information from the preceding chapters of this report and adds detail for each of the larger sources of public-sector revenue in Arizona. **Chapter 16** examines two alternatives that might be considered to improve the management of the state government general fund.

Chapter 17 presents the rationale for a rainy-day fund. It examines the operation and performance of Arizona's budget stabilization fund.

Part IV: Implementing Changes to the Revenue System in Arizona

The last two chapters are largely based on interviews of 24 individuals familiar with the legislative process in Arizona, though published materials also are examined. The focus of these chapters is to identify the factors that have either contributed to, or detracted from, the process of successfully implementing public policy initiatives, especially comprehensive revenue reform.

Chapter 18 focuses on the history of such public policy efforts and draws conclusions as to the factors that have prevented comprehensive revenue reform, and other significant efforts, from succeeding. **Chapter 19** addresses strategies that might be pursued to enhance the likelihood of public policy initiatives being implemented. Both chapters talk about the institutional barriers—term limits, supermajority requirement to raise revenue, Clean

Elections, and the federal Voting Rights Act—that seem to be largely responsible for the lack of significant public policy actions in Arizona since the 1990s.

Dennis L. Hoffman is a professor of economics at Arizona State University. He has published numerous academic articles and a book on macroeconomics and econometrics. Professor Hoffman has received teaching and research awards, including the Distinguished Faculty Research Award in 1992 and Arizona Professor of the Year (by the Carnegie Foundation) in 1997. He has carried the title of Dean’s Council of 100 Distinguished Scholar since 1996. In addition to his academic appointment, Dr. Hoffman is director of the L. William Seidman Research Institute and faculty director of the Center for Competitiveness and Prosperity Research in the W. P. Carey School of Business as well as director of ASU’s Office of the University Economist. Dr. Hoffman’s sponsored research efforts include the construction and maintenance of the tax revenue forecasting model used by the governor’s Office of Strategic Planning and Budgeting since 1982. Dr. Hoffman headed groups of economists who measured the economic impact of several fiscal initiatives for “Fiscal 2000” in 1989. In 2003, he served as technical advisor to the Citizens Finance Review Commission. Dr. Hoffman has conducted considerable contract research over the last several years for a host of business and public organizations across Arizona.

¹ Arizona Joint Select Committee on State Revenues and Expenditures, *Final Report* (November 1989), <http://azmemory.lib.az.us/cdm4/document.php?CISOROOT=/statepubs&CISOPTR=5969&REC=1>.

Chapter 2

AN ECONOMIC PERSPECTIVE ON THE ROLE OF GOVERNMENT AND PUBLIC REVENUE¹

Jeffrey Chapman
Arizona State University, School of Public Affairs

KEY POINTS

- Government exists largely because of the limitations of the private sector: a perfectly competitive private-sector market does not exist in all cases. In particular, the private sector is not well suited to efficiently provide various “public goods,” such as police protection, and infrastructure, such as transportation.
- In response to private-sector limitations, government may regulate certain activities, it might ensure that the provision of desired goods and services occurs, or it may provide the service itself.
- A second reason for the existence of the public sector is that the citizens of developed nations have come to believe that the collective whole, administered through the public sector, should provide a safety net for individuals and families.
- State government in Arizona provides public services through a general fund and a number of other funds. The general fund is dominated by expenditures for education, health and welfare, and public safety.
- Local governments—counties, cities and towns, school districts, and special districts—provide a broader range of services.
- Public services are funded by taxes and user fees, which represent the price paid for the service. However, the public commonly expresses a desire for both increased funding for various public programs and tax cuts.
- Many public functions, particularly infrastructure provision and maintenance, enhance economic development and quality of life.
- State government in particular will confront several significant cost pressures in the coming years that have received little attention.

WHY IS GOVERNMENT NEEDED?

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

A second reason for the existence of the public sector is that the citizens of developed nations have come to believe that the collective whole, administered through the public sector, should provide a safety net for individuals and families. Historical abuses of disadvantaged individuals and severe repercussions from circumstances out of the control of individuals,

such as job losses and other hardships during the Great Depression, led to these social welfare concerns.

Limitations of the Private Sector

The private sector is not well suited to efficiently provide various “public goods:”

- For some goods, one person’s consumption does not subtract from another’s ability to consume. National defense is a classic example. No voluntary pricing mechanism exists. Nor is there a mechanism that can be used to get citizens to reveal voluntarily their true tastes for this service.
- There are other goods for which the price system does not work because consumers will not voluntarily reveal their true preferences. For example, if government asks residents to voluntarily pay for a park, they might believe that their neighbor will also contribute, and so they name an amount considerably less than what the park is worth to them. This attempt to “free ride” results in an inefficient provision of parks.
- The private sector generally cannot provide adequate infrastructure because of immediate high capital costs and revenue that can be realized only in the future. Yet, the benefits of infrastructure affect societal welfare. Schools and public hospitals directly affect education and health levels. Roads and airport facilities directly help economic development. Because of the expense and financing requirements of capital infrastructure, government intervention is often necessary.

In some cases it is impractical or inefficient for private-sector companies to compete to provide a service:

- Sellers and buyers that are large enough to affect prices attempt to underproduce and realize higher prices for their output than the prices that would be determined by an efficient, competitive market. Government may intervene to control prices—such as for electricity—or may otherwise regulate such private-sector activities. In the case of the provision of utilities, a monopoly originally was granted because of the inefficiency of producing multiple water pipelines or electricity transmission lines.
- Municipalities either provide garbage collection themselves or contract with a single private-sector company to provide this service because of the efficiency of having the garbage truck stop at each house in succession rather than drive long distances between customers.

☐ The private sector also is not in a position to resolve differences of individuals. Sometimes households engage in activities that impose costs on others that cannot be recouped. If a consumer has a very noisy car that awakens others at night, there is no way that those awakened can make the noise producer pay within a pure market context. There will be too much noise pollution because its full costs are not counted; economists call this a “negative externality.” The public sector intervenes by limiting such activities.

Other activities generate benefits for others that cannot be charged for. Economists call this a “positive externality.” For example, if an individual repaints the outside of his house, his neighbors may recognize an increase in their property value. However, the owner of the newly repainted house may not be able to obtain compensation for the neighbors’ increased benefits. This can lead to an underproduction of painted houses.

Other examples of market failures exist. In addition, society has determined that there are instances in which the private-sector market should be precluded from working. For example, laws have been passed that prevent vote selling because of the belief that the action is unethical.

In response to these private-sector limitations, government may regulate certain activities, it might ensure that the provision of desired goods and services occurs, or it may provide the service through the public sector. Because these government activities require funding, governments must use the mechanisms at its disposal to raise the necessary funds—that is, to impose a system of nonvoluntary prices through taxes and user fees.

Social Welfare Concerns

The citizens of developed nations have demanded that society should provide a safety net for individuals and families, administered through the public sector. All taxpayers contribute to the funding for the safety net, even though they may never utilize its features. As demonstrated in the recent severe recession, individuals and families that never before had experienced a need for public assistance lost their jobs, health insurance, and homes.

Many factors affect household income, such as education, skill levels, health, age of wage earners, and inheritance. Some of these variables are under the control of the household; others are not. Some argue that one of the functions of government is to attempt to help those who are not fortunate enough to be able to earn an adequate income. At the state and local government level, this is done through the provision of some services, such as education or health services, that help individuals reach their potential, and through direct aid, often in conjunction with work requirements. Some argue that it is a matter of societal responsibility to assist those who need special help, such as elderly residents and those with physical handicaps.

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

Public Services of State and Local Governments in Arizona

Because of the limitations of the private sector and because of the social welfare concerns, government provides a variety of functions. More than half of the federal government’s outlays are for Social Security, Medicare, Medicaid, and related programs. Another 20% is for national defense. State and local government expenditures are largely for education, health and welfare, public safety, and the provision of infrastructure.

State Government

The state of Arizona provides a variety of services, finances some infrastructure, and shares revenues with local governments. State government uses a general fund and a number of specialized funds that receive monies from earmarked sources. The state budget is a complex document, which in recent years has been continually in flux because of recession-caused reductions in revenue and increases in demand for public services.

According to the Arizona Joint Legislative Budget Committee (JLBC), the total budget for all funds in fiscal year 2009, which ran from July 1, 2008 through June 30, 2009, was initially \$28.1 billion.² Significant reductions in the size of the budget were implemented during the fiscal year. Of the original \$28.1 billion, \$9.9 billion was appropriated through the general fund and another \$3.2 billion was appropriated through other funds. Thus, the Legislature appropriated only about 47% of the total funds budget. Most of the nonappropriated monies originated from federal funds. Most of these funds are simply passed through state government to local governments and are earmarked for specific purposes.

The general fund is the focus of most state fiscal analyses because it is the fund over which the Legislature has the most discretion. Table 2.1 shows the general fund allocation for 1979 (the earliest year for which consistent expenditure data are available) and the revised 2009 budget by expenditure category.³ (These and subsequent references to years are for fiscal years unless otherwise noted.) Substantial shifts in relative spending have occurred over time, with large increases in the percentage of the budget going to health and welfare and to protection and safety. Each of the other categories has experienced a decrease in share. In 2009, health and welfare and education combined accounted for 84% of general fund expenditures; adding protection and safety brings the share to more than 95%.

Classified by state agency, six major state agencies accounted for about 91% of the state spending in 2009: Department of Education (43%), universities/Board of Regents (10%), Arizona Health Care Cost Containment System (AHCCCS, Arizona's version of Medicaid, 15%), Department of Economic Security (8%), Department of Health Services (6%), and

Table 2.1
Arizona State Government General Fund Expenditures,
Fiscal Years 1979 and 2009

	2009 (Revised)		Share in 1979	Change in Share, 1979 to 2009
	Dollars in Millions	Share		
Total	\$9,415.1	100.0%	100.0%	0.0%
Education	5,207.0	55.3	69.3	-14.0
Health and Welfare	2,714.5	28.8	15.9	12.9
Protection and Safety	1,068.5	11.3	6.3	5.0
General Government	329.5	3.5	4.9	-1.4
Natural Resources	54.2	0.6	1.4	-0.8
Inspection and Regulation	40.7	0.4	2.2	-1.8
Other	0.8	0.0	0.0	0.0

Source: Arizona Joint Legislative Budget Committee.

Department of Corrections (10%). Each of these large state agencies has subagencies and departments embedded within them, each of which has some budget responsibility; 117 operating agencies and departments are listed in the formal budget document of former Governor Napolitano, ranging from the State Board of Accountancy to the Department of Weights and Measures.

Arizona's initiative process has played an important role in state budgeting. In particular, the state's voters have mandated certain levels of expenditures for education and health services. The federal government also mandates levels of funding for some programs, especially in the health and welfare category, which has received a substantially increased share of the state general fund's expenditures over the last 30 years. The AHCCCS (Medicaid) program has experienced especially large increases; state government did not have responsibility for this program until 1983. While the federal government contributes to the funding, this is a classic case of unfunded mandates passed on to state and local governments.

State government also funds infrastructure, including roads, energy, telecommunications, and water. These expenditures are difficult to itemize as they are scattered throughout the budget of the general fund and other funds. Based on U.S. Census Bureau data for fiscal year 2006, about 10% of direct general expenditures by state government in Arizona were for capital projects.⁴

State government shares a portion of the revenue it collects with local governments. These transfers totaled about \$1.346 billion in fiscal year 2008. The sharing of state revenue consists of five parts:

- Urban revenue sharing: 15% of the net proceeds of the state income tax from two years earlier are distributed to incorporated cities and towns based on population.
- State sales tax: 25% of the transaction privilege tax distribution base is distributed to incorporated cities and towns based on population; 40.51% is paid to counties using a complex formula.
- Highway user revenue fund: 19% of the net state collections of gasoline and diesel fuel taxes as well as other transportation fees are distributed to counties; 72% of the distribution is based on motor vehicle fuel sales by county with the remainder based on population. Another 27.5% is distributed to incorporated cities and towns, with half of the distribution based on population and the other half based on county motor vehicle fuel sales, then population. Another 3% goes to incorporated cities with a population of more than 300,000, based on population.
- Vehicle license tax: Of the revenue generated from alternative fuel vehicles, car rental surcharges, and private ambulances, fire-fighting vehicles, and school buses, 20.45% is distributed to county general funds and an equal percentage goes to incorporated cities and towns, on the basis of population. Another 4.91% is given to counties for transportation-related purposes. Monies collected from other vehicles are shared similarly, but with different percentages: 24.6% to the general funds of both counties and municipalities, and 5.7% to counties for transportation-related purposes.
- Local transportation assistance fund and county assistance fund: depending on the amount of revenue generated by the state lottery, up to \$23 million of lottery revenues are distributed to the local transportation assistance fund on the basis of population. If

all of this \$23 million is distributed, then up to \$7.65 million is placed in the county assistance fund. Most (93.47%) of this money is shared equally among counties with a population of at least 500,000; the balance is shared equally among the remaining counties.

Local Governments

Local governments—counties, cities and towns, school districts, and special districts—are service oriented. They provide education (kindergarten through community college), transportation, public safety (including police, fire protection, and some corrections), and environmental and housing services. In Arizona, local governments provide little health and welfare services, with only 6% of their expenditures for this purpose compared to nearly half of the state government expenditures (see Table 2.2).

Local governments (as well as the state) also are heavily involved in land-use planning and in operating enterprises that provide utilities such as power, water, and gas. The particular advantage of local governments compared to higher-level governments is that they are better able to recognize the tastes and preferences of the residents.

What might be a function of state government in one state may be a local function in another state. Thus, comparing state (or local) government finance figures across states can be misleading. Moreover, state government data reported by the JLBC uses a different accounting system than that used by the U.S. Census Bureau, which reports state and local government finance data for all states.

Table 2.2 shows local government, state government, and combined state and local government expenditures in Arizona in 2006. Using the Census Bureau's accounting, local governments made up nearly 60% of the combined total. As defined by the JLBC, the state's general fund accounted for barely more than one-fourth of total state and local government spending.

Comparing the combined state and local government spending in Arizona to the national total, Arizona's percentages of the total budget spent on education and health and welfare were slightly less than the national average. Arizona's spending shares were higher than average especially in the public safety and environment and housing categories.

However, as indicated in Table 2.3, Arizona's government spending per capita is far below (17%) the average in the United States. Only in public safety did Arizona's expenditures exceed the per capita U.S. average in 2006. In the two largest categories, Arizona's per capita spending was below the U.S. average by 20% for education and by 25% for health and welfare. Based on the alternative measure of expenditures per \$1,000 of personal income, Arizona's public expenditures also are below the national norm, though not by as much. Arizona's per capita personal income is substantially less than the national average.

TAXES AND USER FEES AS PRICES

An ongoing issue at any level of government is to relate the services provided to mechanisms of paying for those services. In many cases, government must provide some minimum level

Table 2.2
Combined State and Local Government Expenditures,
Arizona and United States, Fiscal Year 2006

	Arizona Local Government		Arizona State Government	
	Millions	Share	Millions	Share
Total General Expenditures	\$21,070	100.0%	\$14,678	100.0%
Education	8,881	42.1	3,077	21.0
Health and Welfare	1,310	6.2	7,142	48.7
Transportation	1,502	7.1	1,372	9.3
Public Safety	2,990	14.2	1,161	7.9
Environment and Housing	2,736	13.0	595	4.1
Government Administration	1,588	7.5	579	3.9
Debt Service	903	4.3	405	2.8
Other	1,159	5.5	346	2.4

	Combined State and Local Government Arizona		Combined State and Local Government United States	
	Millions	Share	Millions	Share
Total General Expenditures	\$35,747	100.0%	\$2,121,946	100.0%
Education	11,958	33.5	738,464	34.8
Health and Welfare	8,453	23.6	551,890	26.0
Transportation	2,873	8.0	159,462	7.5
Public Safety	4,152	11.6	189,555	8.9
Environment and Housing	3,331	9.3	164,130	7.7
Government Administration	2,168	6.1	111,308	5.2
Debt Service	1,308	3.7	85,660	4.1
Other	1,505	4.2	121,477	5.7

Source: U.S. Department of Commerce, Census Bureau.

Table 2.3
Combined State and Local Government Expenditures, Per Capita and Per
\$1,000 of Personal Income, Arizona and United States, Fiscal Year 2006

	Per Capita			Per \$1,000 of Personal Income		
	Arizona	United States	Arizona Ratio to U.S.	Arizona	United States	Arizona Ratio to U.S.
Total General Expenditures	\$5,900	\$7,137	83%	\$186.57	\$199.86	93%
Education	1,974	2,484	80	62.41	69.55	90
Health and Welfare	1,404	1,875	75	44.39	52.51	85
Transportation	474	536	88	15.00	15.02	100
Public Safety	685	638	108	21.67	17.85	121
Environment and Housing	550	552	100	17.39	15.46	113
Government Administration	358	374	96	11.31	10.49	108
Debt Service	216	288	75	6.83	8.07	85
Other	240	390	62	7.58	10.91	69

Source: U.S. Department of Commerce, Census Bureau.

of service because of the limitations of the private sector described earlier. Spending beyond that minimal level depends upon the community's demand for that service. However, the necessary provision as well as any desired increment does not come free—the service must be paid for by taxes or user fees. It is often quite difficult to determine which decision comes first. Should the jurisdiction determine the level of service and then raise enough revenue to fund that service level or should the jurisdiction determine how much revenue should be raised and then determine how much of the service can be provided with those revenues?

Public opinion polls do not always provide useful insight to answer this question since respondents often indicate that the levels of most services should increase while at the same time indicating that state and local governments should cut taxes. For example, in a January 2009 survey, more respondents wanted to increase spending than decrease spending on elementary and secondary education, mass transit, freeways, police, universities, and fire protection. Only for prisons and corrections did a larger number want to spend less. In the same survey, 93% of the respondents wanted to cut state taxes.⁵ But, there is no such thing as a “free lunch.” Just as there are costs to increasing service levels, there are also costs to cutting services in order to reduce taxes.

Two basic principles underlie a revenue system. First, if a service provides a benefit to a resident, the resident should pay for that benefit. For example, if a household visits a state park, they should anticipate paying a park entrance fee. Just as with any private good or service, if the household believes that the benefits received from the park exceed the entrance fee, they should be glad that they are getting a good deal. However, if they believe that the benefits are less than the entrance fee, they should not visit the park. Note that benefit charges have nothing to do with the household's income—both rich and poor households pay the same entrance fee in this example—just as private-sector goods and services are not priced on the ability to pay. Property taxes, if thought of as an entrance charge to living in a jurisdiction that provides a particular bundle of services, are sometimes conceptualized as benefit taxes.

Ability to pay (a household's capacity for paying a tax) is the second principle underlying a tax system (determining how to charge for public goods and services). An example of this type of tax is the state income tax—its rates increase slightly as a taxpayer's income goes up. The concept is that wealthier people can afford that last dollar in tax payments easier than poor people can. When ability-to-pay taxes are utilized, it is sometimes necessary to remind people that these taxes are going to finance a portion of government services, and it is necessary to look at both services received as well as taxes paid.

Economists generally believe that residents should be taxed for the public services they consume while businesses ought to be taxed for the public services they consume.⁶ However, based on this principle, businesses are overtaxed throughout the nation. A study that compared business taxes to government expenditures that benefit businesses found that in 2006 the tax-to-benefit ratio was 1.83 nationally, with the lowest state ratio at 1.42.⁷ Arizona's figure was 1.64.

As discussed in Chapter 9, the overall tax burden in Arizona is low, with the personal tax burden very low. In contrast, the business tax burden is moderate overall, but ranges from low among the smallest businesses to high among many of the larger companies (see Chapter 13). State government taxes on individuals are so low that many individuals (especially those with children in the public schools) are not covering their public costs, with the costs shifted to businesses.

Financing the construction of infrastructure represents a separate challenge. Typically, such expenditures are done through debt issuance, though “pay as you go” also is used, particularly in Arizona. Pay as you go implies that no capital investment is made until enough savings have been accumulated to pay for that investment, which may take several years of earmarking money in a special fund. If these savings can be protected (and given the continuing fund sweeps that occur in Arizona, this is demonstrably unlikely), the principal advantage of pay-as-you-go finance is that it minimizes the overburdening of future generations of Arizona residents since they will not have to pay debt service. (In 2006, about 4% of expenditures went to debt service.) However, pay as you go also means that current residents are not getting the benefits of the inbuilt infrastructure, that the economic growth that the infrastructure would stimulate is not occurring, and that once the infrastructure is built, future residents will be enjoying the benefits without having had to pay for them.

Debt finance increases intergenerational equity because debt is typically paid back over a period of 30 years, implying that future inhabitants will be paying a share of the project’s cost as they enjoy the project’s benefits. In addition, inflation will have less effect on the price of the project because of the quicker completion. Further, state and local debt is subsidized through a variety of mechanisms, including the ability to issue the debt at tax-exempt rates (which are below market). The current federal stimulus package offers a variety of debt forms that subsidize debt issuance.

PUBLIC GOODS AND SERVICES AND ECONOMIC DEVELOPMENT

The extensive literature on the relationship between tax breaks and economic development seems to indicate that statewide tax incentives have a statistically significant, but small, effect on development. Other research seems to indicate that economic growth encouraged by low taxes may be seen as increasing demands for public services, thereby placing upward pressure on tax rates faced by the original taxpayers, and so may be counterproductive.⁸

Less research has been done on the effects of state and local government services on development.⁹ Research suggests that government spending on some public services has a positive effect on some measures of economic development in some cases.¹⁰ In particular, transportation and public safety seem to be particularly important to economic growth. Some research indicates that state and local governments can undertake some common-sense activities to stimulate economic development. Some of these activities include maintaining high-quality public infrastructure, having states help local governments create a high quality of life, and carefully dealing with regulations and taxes that could stifle development.

Infrastructure, much of which is provided by the public sector, is of particular importance to economic prosperity. In the early 1980s, arguments began to appear in the media that if

governments had more effectively managed infrastructure, its deterioration would not have occurred and economic productivity would be higher. These accusations encouraged a more rigorous study of the relationship between infrastructure and economic growth. It is sometimes hypothesized that public infrastructure can affect economic growth by increasing labor productivity, increasing the durability of private capital, and helping in private capital formation. In general, most of the studies have found that accumulation of infrastructure is important for productivity gains.¹¹ Rates of return to infrastructure investment seem to range from 25–50%, although the returns differ by geographic area and time period. Some argue that the maintenance of existing infrastructure may be as important as its actual provision.

Public spending can help cities develop in many ways. For example, helping neighborhood schools improve, making the streets safe, creating a competitive cost climate for businesses and residents, helping investment in downtown revitalization, investing in catalytic development projects, and creating marketable sites for development have all been suggested.¹² Many economists strongly believe that direct spending reductions during a recession will generate more adverse economic consequences in the short run than either tax increases or transfer program reductions, because tax increases or transfer payment reductions would reduce savings rather than consumption, lessening their impact on the economy.¹³

It is reasonably clear that regions are fiercely competitive in their desire for economic development. While much of the discussion has revolved around cutting taxes to establish a better business climate, the availability of quality public infrastructure and services—largely paid for by taxes—also improves the business climate.

FUTURE EXPENDITURE CONCERNS

Government, particularly at the state level, will confront many pressures over the next several years. Since state and local governments must balance their budgets, these pressures call for significant changes in the revenue system and/or in public expenditures. This chapter concludes with three examples—infrastructure, health care, and retirement benefits—but there are many more relating to education, court and voter mandates, and so forth.

A recent study that analyzed Arizona infrastructure needs over the next 25 years found that the state faces revenue gaps of many billions of dollars for new capital investment in energy, telecommunications, transportation, and water.¹⁴ While the federal stimulus plan has included within it several ways of beginning to attack these gaps, the available funding is in the magnitude of \$700 million.¹⁵ Several new tax-credit bond programs are available for capital construction.¹⁶ These bonds make it less expensive to the state to finance infrastructure improvements, if the state is willing to enter the debt market.

Nationally, Medicaid spending has doubled in the last 15 years. Two-thirds of the spending is for the elderly and disabled. A one-percentage-point rise in the unemployment rate causes an increase of 400,000 nonelderly adults in Medicaid and adds 600,000 children to the State Children's Health Insurance Program. The Government Accountability Office (GAO) in January 2008 argued that Medicaid and health insurance for state and local government employees and retirees (retirement is discussed below) is the primary driver of the fiscal

challenges facing state and local governments. The GAO forecasts a deficit of 1% of gross domestic product (GDP) for state and local governments by 2010 and a 4% deficit by 2050 unless the system is substantively changed.¹⁷

Although Arizona does not spend as much on Medicaid as many other states—in some states it is now the largest single expenditure item—demand for the Arizona Health Care Cost Containment System generally follows the national pattern, though the state's population growth causes the rate of increase to be higher. In addition to the trend growth, sharp increases currently are occurring due to the economic recession. AHCCCS rolls grew by about 46,500 in just two months (June and July of 2009) and over the year experienced a growth rate of 16%. The estimated 2010 shortfall is \$253 million.

A third example of the increasing expenditure pressures facing state and local governments is the interrelated pension and other post-employment benefit situation. Health insurance is the primary post-employment benefit other than the pension.

Most state and local government employees in Arizona belong to the Arizona Retirement System, a defined benefit plan (university professors have this as an option).¹⁸ Under a defined benefit plan, employee and employer contributions as well as the investment earnings on these contributions fund the benefit payouts. A fully funded system will have adequate accumulated assets to meet the benefits earned by the participants at the time of retirement. In Arizona, various parts of the retirement system are funded at different ratios—the retirement portion of the plan is 82.1% funded, health insurance premiums is 85.7% funded, defined contribution retirement is at 102.2%, and the long-term disability program is at 49.7% (all estimates for June 30, 2008). The unfunded actuarial accrued liability (based on an overall funding ratio of 82.8% for the entire plan) is about \$5.5 billion.

Contribution rates, which are evenly split between employer and employee, are 18.8% for the current fiscal year. The contribution rates of the current year and the three previous years are the highest during the last 30 years. These rates are expected to rise further in the next three years, perhaps by as much as a full percentage point.

These increasing costs will put a large burden on state and local governments. Solutions to the general pension problems might include moving to a defined contribution plan (which does nothing for the existing unfunded liability), cutting benefits, increasing the age at which retired employees receive full benefits, and ending other expensive retirement options.

Solutions for the other post-employment benefit problems are equally difficult: put a dollar cap on annual benefits; reduce benefits for pre-Medicare retirees by increasing co-pays, deductibles, or other costs; limit the period of pre-Medicare retiree benefits that plans pay; or eliminate inflation increases for retirees who terminate prior to reaching Medicare age.¹⁹

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¹ Isaiah McCoy and Junk Wook Seo contributed to this chapter as research assistants.

² Arizona Joint Legislative Budget Committee, *FY2009 Appropriations Report* (August 2008), <http://www.azleg.gov/jlbc/09app/apprpttoc.pdf>.

³ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc/fiscal.htm>.

⁴ U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

⁵ Michael J. O'Neil, "What We Want Depends on Question," *The Arizona Republic* (January 4, 2009): B12.

⁶ See, for example, Robert P. Inman, "Financing Cities," in *A Companion to Urban Economics*, ed. Richard Arnott and Daniel McMillen (Malden, MA: Blackwell Publishing, 2006): 311-331.

⁷ Andrew Phillips, Robert Cline, and Thomas Neubig, *Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2008* (Ernst & Young, January 2009), [http://www.ey.com/Publication/vwLUAssets/Total_state_and_local_business_taxes_50_state_estimates_for_fiscal_year_2008/\\$FILE/Total_state_and_local_business_tax_fiscal_year_2008.pdf](http://www.ey.com/Publication/vwLUAssets/Total_state_and_local_business_taxes_50_state_estimates_for_fiscal_year_2008/$FILE/Total_state_and_local_business_tax_fiscal_year_2008.pdf).

⁸ See Shelby Gerking and William Morgan, "State Fiscal Structure and Economic Development Policy," *Growth and Change* 29, no. 2 (Spring 1998): 131-145, <http://www3.interscience.wiley.com/cgi-bin/fulltext/119106825/PDFSTART>.

⁹ The effects of taxes on development have been long controversial, with results changing with improvement in econometric techniques. For a survey of the literature, see Michael Wasylenko, "Taxation and Economic Development: The State of the Economic Literature," *New England Economic Review* (March/April 1997): 37-52, <http://www.bos.frb.org/economic/neer/neer1997/neer297c.pdf>.

¹⁰ For a survey of the literature, see Ronald C. Fisher, "The Effects of State and Local Public Services on Economic Development," *New England Economic Review* (March/April 1997): 53-67, <http://www.bos.frb.org/economic/neer/neer1997/neer297d.pdf>.

¹¹ For a literature survey, see Stéphane Straub, *Infrastructure and Development: A Critical Appraisal of the Macro Level Literature* (Washington D.C.: World Bank Policy Research Working Paper 4590, April 2008), http://www-wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2008/04/14/000158349_20080414115839/Rendered/PDF/wps4590.pdf.

¹² Jenifer S. Vey, "Revitalizing America's Older Industrial Cities: A State Agenda for Change," *Retooling for Growth* (Washington D.C.: Brookings Institution, 2008), 33-60.

¹³ Nicholas Johnson, quoting Joseph Stiglitz and Peter Orzag, *Budget Cuts or Tax Increases at the State Level: Which is Preferable During a Recession?* (Washington D.C.: Center on Budget and Policy Priorities, January 12, 2009), <http://www.cbpp.org/cms/index.cfm?fa=view&id=1032>.

¹⁴ Arizona Investment Council, *Infrastructure Needs and Funding Alternatives for Arizona: 2008-2032* (Tempe, AZ: L. William Seidman Research Institute, W. P. Carey School of Business, Arizona State University, May 2008), http://www.arizonaic.org/images/stories/pdf/AIC_FINAL_report.pdf.

¹⁵ These are figures from the "Federal Funds Information for States," *State Policy Reports* 27 (February 2009).

¹⁶ Government Finance Officers Association, *Issue Brief: Taxable Tax-Credit Bonds Programs* (Washington D.C.: GFOA Federal Liaison Center, 2009).

¹⁷ David M. Walker, "Long-Term Fiscal Outlook" (testimony before the Committee on the Budget, U.S. Senate, GAO-08-411T, Washington D.C.: Government Accountability Office, 2008), <http://www.gao.gov/new.items/d08411t.pdf>.

¹⁸ All data come from the Arizona State Retirement System, *Comprehensive Annual Financial Report for Fiscal Year Ended June 30, 2008*, <https://www.azasrs.gov/web/Publications.do>.

¹⁹ Girard Miller, "Medicare Trumps the 'OPEB Fairy,'" *Governing* (May 21, 2009), <http://www.governing.com/column/medicare-trumps-opeb-fairy>.

Chapter 3

PRIMER ON STATE AND LOCAL GOVERNMENT REVENUE¹

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KEY POINTS

- Nationally, the majority of state and local government revenue comes from the property, sales, and income taxes, in relatively equal shares. The property tax in essence taxes wealth, the income tax is levied on earnings, and the sales tax is applied to consumption.
- More narrow taxes, such as on the purchase of alcoholic beverages and gasoline, and user fees are other significant sources of state and local government revenue.
- The sales tax base in most states, including Arizona, is largely limited to nonfood goods. With an increasing share of consumer expenditures going to untaxed services and untaxed goods purchased through the Internet, the sales tax base is not providing revenue that is expanding as fast as the general economy.
- The property tax tends to be the steadiest source of revenue of the major revenue sources. The narrow tax base of the sales tax contributes to fluctuations in collections over the course of an economic cycle. Personal income tax collections vary considerably, largely due to the volatility in capital gains. Corporate income tax collections are even more volatile.
- Since the three major taxes do not rise and fall by the same magnitudes over an economic cycle, tax experts recommend using all three sources in order to provide more stable revenues over time.
- The sales tax code in Arizona is complex due to multiple tax rates across jurisdictions and a multitude of exemptions.
- Arizona's property tax code is extraordinarily complex and favors homeowners at the expense of other taxpayers.

THE BASICS OF STATE AND LOCAL GOVERNMENT REVENUE: NATIONAL PERSPECTIVE

Nationally, more than 20% of the total revenue available to state and local governments in fiscal year 2006 originated as a transfer from the federal government. State and local governments have little discretion over the use of these federal funds, which must be spent for specific purposes. Thus, the focus of most analyses of state and local government revenue systems is “own-source” revenue, which is collected mostly from taxes and user fees assessed by state or local governments.

Most states rely on a combination of three major taxes to provide the majority of nonfederal government revenue: sales tax, property tax, and income tax (personal and corporate). Commentators refer to these taxes as the “three-legged stool” of government revenue,

implying the need for all three tax bases and a relatively equal reliance on all three to create the most balanced tax structure. These three taxes are each broad based and apply to somewhat different aspects of the economy: consumption, wealth, and earnings, respectively. Each is somewhat differentially affected by the economic cycle.

Nationally, these three taxes accounted for 56% of own-source state and local government revenues in fiscal year 2006.² More narrowly applied taxes accounted for an additional 13%. The most commonly levied of these other taxes are luxury (or “sin”) taxes (e.g., taxes applied on alcoholic beverages, cigarettes, and gambling), gasoline taxes, mineral taxes (taxes applied on the extraction of minerals), and the real estate transfer tax.

User fees (such as tuition at public universities, local government impact fees, and real estate licensing fees) accounted for nearly one-fifth of state and local government revenue nationally in fiscal year 2006. (The U.S. Census Bureau, the source of the statistics cited in this section, uses the term “current charges” instead of “user fees.”) The balance of state and local government revenue comes from interest earnings and a variety of other sources.

Property Tax

The property tax is applied to real property (land, buildings, and improvements to the land) and personal property within the state’s jurisdiction. Furniture, equipment, and tools used for commercial purposes are taxed as personal property. For reasons related to the legal rights of sovereignty, the customs of federalism, and the impracticality of taxing oneself, states do not apply property tax on real property within the jurisdiction owned by Native American tribes, the federal government, or the state itself, respectively.

Most states apply the property tax on a selected basis on privately owned personal property within the jurisdiction. The most common property tax on personal property incorporates motor vehicle registration and license fees, which are based on the value of the vehicle. However, this is classified as a vehicle license tax, not a property tax, in Arizona.

Mobile and manufactured homes also are considered to be personal property and are taxed. (However, a mobile/manufactured home permanently affixed to land owned by the owner of the home is considered to be real property.) For reasons related to the administrative difficulty of performing periodic valuations of individual household personal property and assets, states have departed from the practice of applying property taxes on most residential personal property. States still generally apply a property tax on the personal property of businesses, which primarily affects capital-intensive businesses, such as utilities and manufacturing companies. High-technology manufacturers, which use high-value equipment, tend to be particularly affected.

All states levy a property tax at local government levels. In Arizona, most local governments—including school districts, counties, cities and towns, community colleges, and special districts—receive funding from the property tax, with school districts receiving by far the largest amount. Arizona state government, like many state governments, receives little revenue from the property tax.

Property taxes are primarily collected at the local (i.e., county) level and then remitted to the state. Collections take place annually or semiannually. The large amounts are noticeable and contribute to making the property tax unpopular. With mortgage lenders collecting a portion of annual property taxes on a monthly basis from some borrowers, homeowners with continuing escrow accounts may not perceive the impact of the property tax in the same way as individuals who write the payment check themselves. Renters also typically do not know the magnitude of property taxes that they pay: the property tax is one of the factors that determine the amount of rent charged.

Regular appraisals of the property being taxed are a necessary component to assessing a property tax. Appraisals are based on complex formulas that vary from state to state. The valuation formulas typically include a market component, and thus the property tax moves up and down with fluctuations in fair market value. However, the valuations generally have artificial caps on how much a valuation may change from year to year so property tax valuations usually are not equal to the fair market value of the real property.

The property tax tends to be the steadiest of the major revenue sources, with collections fluctuating the least from year to year. Moreover, the public-policy problems associated with property tax, such as the effect of the tax on fixed-income elderly homeowners who may be cash poor despite free and clear property ownership, can usually be alleviated through relatively simple, targeted measures, such as income tax credits. In Arizona, a constitutional provision allows the valuation of property owned by low-income senior citizens to be frozen.

Sales Tax

Forty-five states collect what is generally termed a sales tax. However, the legal burden of the tax varies by state. Technically, some states, including Arizona, levy a “transaction privilege tax” in which the seller is responsible for remitting the tax. Sales taxes are levied as a percentage of the sales price of the good or service purchased, but the goods and services taxed vary from state to state.

There are six generally and widely accepted exemptions to the sales tax base, that is, sale transactions to which no sales tax applies:

- Exemption due to federal pre-emption or sovereignty. The concept of federal pre-emption in tax collection is that a state does not have the legal power to tax the federal government or an agent thereof. The concept of sovereignty in tax collection is that one government entity does not have the jurisdiction to tax another sovereign entity (such as another nation or a Native American tribe). A related concept limits the breadth of a state’s jurisdiction, legally preventing a state from taxing an entity that does not have sufficient nexus with the state. This is the legal concept that prevents states from taxing purchases from Internet companies that have no physical presence within the state.
- Exemption to avoid double taxation. The sales tax is borne only by the ultimate purchaser of the taxed product. Wholesalers thus are exempt from paying sales tax. In addition, purchasers of parts for the manufacture of machines for ultimate resale generally do not pay sales tax on the purchase of component parts. If the sales tax were applied at every level of purchase in the manufacturing chain, the ultimate

- purchaser would be paying taxes not just on the value of the machine purchased, but also on the taxes applied at each level.
- Exemption for ease of administration. There are some transactions for which collecting sales tax is administratively difficult. An example in Arizona is the exemption on the collection of a sales tax in the resale of an individual's car to another, when the seller is not a "dealer" as defined by statute. In this rather limited category of exemptions, policymakers have decided the cost of educating the public, collecting the tax, and assessing it fairly is greater than the revenue collected.
 - Exemption for nonprofit endeavors. Policymakers have long supported an exemption from the sales tax for nonprofit organizations recognized as such under the law.
 - Exemption for certain goods and services considered "basic needs." Perhaps to balance out the relatively regressive nature of the sales tax, policymakers have excluded certain "basic needs" goods and services from sales taxation. The most common exemptions of this type are for grocery food items and prescription drugs.
 - Exemption to support an economic development policy or industry. While created to boost economic development, such exemptions frequently are criticized as subsidizing an industry and as picking winners and losers.

Sales tax exemptions frequently are criticized as being the product of political lobbying rather than rational tax policy.

Sales tax revenue is less volatile than income tax collections, but still is subject to considerable cyclical ups and downs. In many states, the sales tax has provided an increasing share of government revenues due to increases in the sales tax rate, while rates have been lowered for the other two major taxes. Some states, including Arizona, rely heavily on the sales tax.

A growing refrain from tax policy analysts is that there is a long-term problem with heavy reliance on sales tax revenue. In most states, the sales tax base was developed in the 1930s and is limited to goods. In the 1930s, manufacturing dominated the United States economy and the purchase of goods made up the majority of household expenses. Over time, households are spending more and more money on services, which are generally not taxed. Prior to 1960, less than 40% of the nation's personal consumption expenditures were for services (except during the depths of the Great Depression). By 2008, this share reached 60%. Relying on sales tax revenue as currently structured is "like riding a horse that is rapidly dying," according to James Hite, a professor teaching tax policy at Clemson University.³

In addition, the growth of Internet sales of goods is eating away at the sales tax base. States cannot tax a sale by a party that does not have adequate legal nexus with the taxing state. Virtual or Internet companies that have no physical presence within a state but ship goods for sale to a buyer within a state may be beyond the legal power of the local taxing authorities. Brick-and-mortar businesses competing with such virtual or Internet companies complain bitterly about the economic disadvantage placed upon them.

As a result of the shift in consumer expenditures to untaxed services and untaxed Internet goods, sales tax collections are not rising as quickly as gains in the overall economy. In

Arizona, taxable retail sales as a share of personal income have steadily fallen over the last 25 years. At the cyclical peak, the share was 32% in the mid-1980s, 30% in the mid-1990s, and 28% in the mid-2000s. At the cyclical trough, the share fell from 28% in the early 1990s to 27% in the early 2000s to only 23% in 2008.

Personal Income Tax

The personal (or “individual”) income tax generally is assessed on income earned (including wages from employment, distributions from partnerships, capital gains from passive stock ownership, and interest earnings). Forty-three states levy a personal income tax, but two of these states limit the tax to earnings from dividends and interest. In a few states, local governments also can levy an income tax.

In most states, the net income on which the personal income tax is assessed begins with the federal adjusted gross income, from which a state may add certain income that is exempt under federal rules or take out income that the state considers exempt. (For example, Arizona’s allowable deduction for medical expenses is more generous than the federal equivalent.) Reductions in income tax may come in the form of “deductions,” which are reductions on the net income on which income taxes are assessed, or the more generous “credits,” which are dollar-for-dollar reductions on the net income tax liability owed.

Revenue from the personal income tax is more elastic than from the property or sales taxes, fluctuating the most from year to year based on the health of the overall economy. Most of the variation comes not from fluctuations in wages and salaries, but rather from investment income. In particular, capital gains have been especially volatile over the last 15 years, a result of sharp fluctuations in the stock market and in the housing market.

Unincorporated businesses—small in size but numerous—also file income taxes using the personal income tax. The volatility in the income of small businesses also contributes to the variability in tax collections from this source.

Corporate Income Tax

Only a few states do not levy a corporate income tax. Since the tax applies only to corporations—a relatively small portion of all businesses—collections from this source are significantly less than collections from the personal income tax. The corporate income tax accounted for less than 5% of total state and local taxes collected nationally in fiscal year 2006. Collections were only about one-fifth the magnitude of personal income tax collections. Corporate income tax revenue is highly volatile, fluctuating more than the personal income tax during an economic cycle.

Understanding how corporate income tax revenue is assessed is difficult. Large accounting firms have entire departments devoted to just corporate state and local government income tax management. The tax is assessed on the annual net income of a corporation, but the formula is complicated by the fact that many corporations are located in multiple states. Describing the formula in a crude fashion for the sake of brevity, the multistate corporation’s income is divided among the states it operates in based on a formula related to the percentage of employees, real property, and sales that occur within the state. Each state, however, may

calculate the formula differently, making it theoretically possible for a corporation to be paying taxes to more than one state on the same income or for there to be some income on which no income tax is assessed.

In recent years, a number of states, including Arizona, have changed their employee, real property, and sales tax formula to more heavily weight the sales factor. Thus, the percentage of total corporate income that is taxed by a state relies more and more on that percentage of sales that occurs within the state. This benefits companies that export their goods out of the state. A more heavily weighted sales factor formula benefits an export company like Intel relative to a local retailer like Bashas⁷.

Another reason corporate income tax levels may be so small a portion of a state's overall tax revenue base is that corporations engage in creative restructuring to lower their tax liability. Some restructure to move taxes to low-tax jurisdictions or structure as partnerships, which do not pay the corporate income tax.

PECULIARITIES OF ARIZONA'S REVENUE SYSTEM

Arizona's revenue system is unusual in some regards. A political characteristic of note is that any state revenue increase requires a two-thirds majority vote by the Legislature, but revenue reductions only require a simple majority. See Chapter 5 for details. Tax cuts have proven to be easier to enact than tax increases and once enacted are for all practical purposes permanent. This is one reason Arizona tax policy analysts prefer a tax rebate rather than a permanent tax cut when there is a budget surplus.

Mix of Tax Sources

Combined, state and local governments in Arizona are much more dependent on the general sales tax than the national average. Lesser shares of revenue come from the personal income tax, user fees, property tax, selective sales taxes, and miscellaneous taxes (see Chapter 9). The comparison is more exaggerated when looking only at state government (see Chapter 7).

Nationally, the property tax provided 21% of state and local government revenues in 2006, with income taxes accounting for 19% and the general sales tax for 16%. In Arizona, however, the sales tax accounted for 27% of the total. Despite this heavy reliance on the sales tax, Arizona's state and local government revenues were more balanced among the three primary sources than in most states.

Complexity of the Property Tax

Arizona's property tax system is highly complex.⁴ This discussion only touches on the complexity. The first distinction is between the primary property tax, which is used to finance maintenance and operations of local governments, and the secondary property tax, which is used to pay off bond indebtedness.

The assessed value of a property is estimated annually by the county assessor. The following information, obtained from the Arizona Joint Legislative Budget Committee and the Pima County Assessor's Office,⁵ illustrates the lengthy process for determining the 2010 full cash value of a property and then levying the tax:

- Using sales from January 2006 through September 2008, the value as of January 1, 2009 had to be determined by December 15, 2008.
- By March 1, 2009, the 2010 notice of value was mailed to property owners.
- Property owners had 60 days to file an appeal to the county assessor.
- The county assessor had until August 15 to rule on all appeals and send notice to property owners.
- Property owners had 25 days to appeal to the County Board of Supervisors or, for property owners in Maricopa and Pima counties, the State Board of Equalization.
- Appeals from the second stage had to be ruled upon by October 15.
- Property owners had 60 days to file an appeal with the state tax court.
- In December 2009, the tax roll is certified.
- In August 2010, tax rates are adopted.
- In September 2010, tax bills are mailed. The payment for the first half of the year is due on October 1, 2010; the payment for the second half is due by March 1, 2011.

Thus, the tax year lags the valuation year by one year and payments are due in the fiscal year after the tax year.

In a typical period of rising property values, this lengthy process results in a long delay before the property owner must pay based on the increase in value. This delay is particularly noteworthy in the case where a home is built on a lot previously assessed as vacant land. In the recent environment of falling real estate values, property owners must wait to realize the impact on their tax bill of the reduced valuation.

In addition to the full cash value, which in essence is equal to the market value, a limited property value, which cannot increase more than 10% per year, is determined. The tax liability is calculated by multiplying the limited property value by an assessment ratio to get to the “net assessed valuation.”

Nine legal classes of property are defined in Arizona, with the assessment ratios varying across these classes. The highest ratio, which is in the process of declining from 25% in 2005 to 20% in 2011, is for commercial property. In contrast, the residential assessment ratio is only 10%.

The net assessed valuation is multiplied by the tax rate to determine the tax liability. The tax rate is a combination of multiple tax rates of several overlapping jurisdictions, such as county, municipality, school district, and special district. Thus, the tax rate varies across the state, and even within individual cities. There are more than 3,000 taxing authorities in the state: 410 for the primary property tax and the balance for the secondary tax.

In addition, a variety of tax exemptions and tax limitations affect the actual amount of property tax paid. A number of the limitations are specific only to residential properties. The effect of limiting the residential property tax is to shift the tax burden onto other taxpayers, particularly businesses.

The homeowner’s property tax rebate reduces the school district primary tax levy. The rebate is the process of going from 35% in 2005 to 40% in 2010, with the cap on the amount of the

rebate moving from \$500 to \$600. In addition, the total primary property tax levy cannot exceed 1% of the value of the residential property. Further, the primary property tax can rise only 2% per year.

In addition to the real property tax, commercial businesses pay a personal property tax, which is assessed on an annual basis on the value of depreciating capital assets owned by the company. Thus, more capital-intensive businesses pay more taxes.

Complexity of the Sales Tax

Arizona's state sales (technically, transaction privilege) tax rate of 5.6% is 23rd highest of the 50 states. Passed by the voters in 2000, 0.6% of the tax is earmarked for education and does not enter the state's general fund.

Due to cities and counties levying an additional sales tax, the total sales tax rate is higher and varies across the state. Further, the goods and services taxed vary by jurisdiction. County tax rates range from 0.25–1.125%. Cities levy a tax ranging from 1.5–4%. The typical total sales tax rate in a municipality is from 7.8–9.7%, with three cities having totals in excess of 10%. These are relatively high rates that have some policy analysts concerned that the tax rate is distorting buyers' behavior.

The total sales tax rate has increased over time in Arizona, following the national pattern. One reason Arizona voters and policymakers favor the sales tax is that it is exportable to nonresidents: seasonal residents and tourists also pay the tax. However, sales taxes are considered more regressive than most taxes because lower-income consumers spend a greater portion of their total income on taxed goods. To address this concern, grocery food items are exempt from the 5.6% statewide rate—but some cities still tax food.

Perhaps in part because Arizona's combined state, county, and municipal sales tax rate is high and rising, the number of sales tax exemptions have expanded during the last 25 years. According to the Morrison Institute for Public Policy, the number of exemptions rose from 22 in 1980 to 121 in 1999.⁶ An analysis by public and private accounting and tax analysts on behalf of the Citizens Finance Review Commission identified 220 exemptions as of 2003.⁷ In an exemption-by-exemption analysis, the research group recommended that only 79 of the exemptions be retained, 113 be repealed, and further study be conducted on two. The estimated revenue in 2003 from the repeal of the 113 exemptions exceeded \$900 million.

Cyclical Revenues

Another characteristic of Arizona's revenue system is that tax revenues are highly sensitive to changes in the economy (see Chapter 10). This cyclical nature creates significant problems. The basic issue with cyclical revenue is that the demand for government services is noncyclical—unlike the demand for most private-sector goods and services. In fact, demand for some public programs is countercyclical, going up when the economy is down.

Arizona policymakers addressed this cyclicity by instituting a budget stabilization fund in 1990 (see Chapter 17). However, the original budget stabilization fund statute was changed by the Arizona Legislature in 1995, reducing the maximum amount of money placed in this

“rainy-day” fund from 15-to-5% of the general fund. The limit was subsequently raised, reaching 7% in 2000. A fund capped at this percentage has proven to be greatly inadequate to offset the budget deficits experienced during the two economic recessions that have occurred since that time.

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¹ This chapter is an update to a portion of Chapter 7, “Aligning Arizona’s Tax Structure to Meet Our State’s Rapid Growth,” in the 89th Arizona Town Hall background report, *Arizona’s Rapid Growth and Development: People and the Demand for Service* (2006).

² U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

³ Katherine Barrett et al., “The Way We Tax: A 50-State Report,” *Governing Magazine* (February 2003), <http://www.governing.com/gpp/index.htm>.

⁴ For an excellent summary of this complex property tax system, see Citizens Finance Review Commission, Property Tax Research Committee, *Effects of Eliminating the Distinction between Full Cash and Net Limited Property Value on Property Tax* (2003), <http://www.azcfrfrc.gov> under “Research Reports.”

⁵ Office of the Pima County Assessor, http://www.asr.pima.gov/pdf/2010Valuation_timeline.pdf, and Arizona Joint Legislative Budget Committee, *2008 Tax Handbook*, <http://www.azleg.gov/jlbc/08taxbook/08taxbk.pdf>.

⁶ Arizona State University, Morrison Institute for Public Policy, *Five Shoes Waiting to Drop* (October 2001), 43, www.asu.edu/copp/morrison/apc2001.htm.

⁷ Citizens Finance Review Commission, Transaction Privilege Tax Research Committee, *Transaction Privilege Tax: Suggested List of Exemptions for Elimination* (2003), <http://www.azcfrfrc.gov> under “Research Reports.”

Chapter 4

THE RELATIONSHIP BETWEEN TAXES AND ECONOMIC GROWTH

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KEY POINTS

- Developed economies, as in Arizona, must rely on innovation and technological progress in order to maintain economic growth. Education and research and development are keys, while cost factors, including tax burden, are of lesser importance to economic development.
- Businesses that sell (export) their goods and services to customers outside the region drive the regional economy. Economic base activities that are mobile, such as manufacturing, are of special importance.
- State and local government taxes have only a small effect on economic growth. These taxes are small relative to federal taxes and to other business expenses, and represent the price paid for public services used by businesses and individuals.
- Arizona's tax burden on individuals is very low relative to other states, but this has little effect on the state's export sectors that drive economic growth.
- Most of the tax cuts implemented since the early 1990s in Arizona have been to personal taxes that already were low from a national perspective. Some business taxes remain high.
- Tax reductions boost economic growth only when the tax burden is relatively high. In order for a tax reduction to have a net positive effect on public-sector finance, a region must have underutilized resources.
- The tax cuts and tax increases passed in Arizona over the last 30 years have not had any perceptible effect on the state's economic growth. The tax cuts have lowered government revenues, contrary to claims of enhanced revenues made by some supply-side adherents.

ECONOMIC GROWTH¹

Economic growth and development occurs in stages. Once development begins, it proceeds in similar ways across countries:

- In the early stage of development, labor flows *from* agriculture *into* industry and services.
- In a later stage, labor flows *from* agriculture and industry *into* services.
- As countries further progress, they purchase modern capital such as machinery and equipment from the advanced economies and adopt the advanced production techniques appropriate for their level of development. Countries in this so-called "catch-up" phase of development become competitive relative to the leading countries.

- When the catch-up phase comes to an end, the country has a developed economy and enters the advanced phase of economic growth. Innovation through technological progress then becomes the key to further growth.

Existing industries in developed economies are subjected to global competition from the next wave of low-wage global competitors in their own catch-up phase. As “catch-up” countries compete successfully at lower costs for the older established industries, firms in these industries in the advanced economy are forced to exit the market. Unable to compete on wages and other cost factors, leading economies must innovate in order to continue to grow economically.

Economic Growth in the United States

The United States has a developed economy. As discussed in Chapter 2, the private sector is not always well-suited to efficiently provide various public goods. Thus, in order for the nation to successfully compete, the federal government must be an active participant.

The federal government in particular is a key player in supporting research. Because ideas are the product, research and development (R&D) is not like other products. Knowledge cannot easily be restricted. Its ownership is difficult to determine and even more difficult to confine. As such, the development of R&D provides spillover benefits to other users of the ideas, and hence, the broader economy. It follows that the developers of R&D cannot obtain the full rate of return for the invention because of the spillover. Hence, the private-sector will underproduce R&D from the perspective of society, and the government can be justified in intervening. Intellectual property regulations and subsidies for basic research are common methods of intervention.

R&D has an obvious direct effect on innovation, and hence productivity, and an indirect effect of causing accumulation of new technologically efficient capital. The secondary effect can be very large. Furthermore, advances in R&D create new knowledge that becomes available to others at no cost, inducing still more innovations at lower cost than the original discovery. R&D is especially crucial for the invention process of leading economies. In contrast, emerging economies can simply adopt the leading technologies from the developer of the technology.

The closer to the technological frontier, the greater is the impact from expenditures on research universities. Higher education also improves economic performance because education is required for many high-skilled jobs and for producing cutting-edge technology. Education also gives workers the flexibility to adjust to technological innovation.

Policies and institutions that promote competition and facilitate entry of firms and industries with new technologies and exit of companies and industries that utilize old and inefficient technologies are instrumental to economic gains in an advanced economy. Markets that work most effectively will allocate resources freely across competing uses to the ones that are most likely to result in growth. By extension, protection of industries, firms, products, and jobs reduces efficient turnover.

Each of the states within the United States has a developed economy. The states compete not only with each other but with countries around the world. Countries in the catch-up phase are the competition for products using older technologies while other developed countries compete for newer products.

For a local economy to be competitive, state and local governments must provide certain services:

- Government has a role in providing economically efficient access to the market for education. Without government intervention, the private sector will underproduce educational services, human capital accumulation will be inefficiently low, and growth in living standards will suffer. Moreover, to compete in a developed economy, research universities must be present.
- Modern physical infrastructure must be present to compete economically. There is a role for government involvement with respect to efficient transportation and communication networks, including cost-effective access to private or public “rights of way” in corridors, trenches, conduits, tower sites, etc.
- Just as the federal government should get out of the way of market forces, state and local governments should not protect existing companies and industries.

Enough revenue must be collected from taxes and other sources to pay for the public institutions and infrastructure that promote growth, without imposing excessive tax rates. In the advanced stage of economic growth, cost factors, including tax burdens, become less important than in the earlier stages of growth, while education and research and development become more important.

The Measurement of Economic Growth

The rate of change of real (inflation-adjusted) gross domestic product (GDP) per employee (or per capita if employment data are not available) is used by economists as the proper unit of measurement when comparing economic growth over time or across regions. GDP per employee is a measure of the productivity of the economy.

Gains in GDP per employee are tightly correlated with advances in real wages. Thus, productivity gains drive improvements in living standards. Indeed, without productivity gains, there are no improvements in living standards, on average. Over a long time period, small differences in economic growth rates have a very large impact on standards of living.

Economic Base and Population-Serving Industries

Some sectors of the economy, such as manufacturing, are highly export oriented. Other sectors, such as retail trade, predominantly sell their goods and services to local residents and businesses. Those businesses that sell (export) their goods and services to customers from outside the region form the economic base of any region, regardless of whether the region has an underdeveloped or developed economy. It is the export activities that drive any economy. Without such activities providing jobs, the population-serving activities would not exist.

Export activities take many forms. The classic examples are agriculture and mining, whose locations are dependent on local attributes of the land. These sectors are not mobile.

In contrast, most manufactured goods are sold to customers from outside the region, and most manufacturing activities can locate anywhere. Regions compete with the rest of the world for manufacturing facilities. Similarly, companies in many other sectors sell at least a portion of their goods and services to customers outside the region and can locate elsewhere. The presence in a region of such mobile export businesses is due to the region's business climate. A long list of regional factors—including availability, quality and cost of the workforce; quality of life; and tax policy—determine the business climate and influence location decisions of manufacturers and other export businesses.

Tourism and retirement migration also are basic economic activities. They are like agriculture and mining in that their presence is in part due to local natural attributes (such as climate, mountains, and bodies of water). However, the aspects of quality of life that are determined by human decisions and activities also influence the number of tourists and retirement-aged migrants that any region receives.

Just as private-sector markets that work most effectively allocate resources freely across competing uses to the ones that are most likely to result in growth, public-sector policies need to distinguish between economic-base and population-serving industries to the extent possible in order to maximize competitiveness and economic growth.

TAXES AND ECONOMIC GROWTH

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

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

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

State and local government business taxes receive attention because many state and local governments grant tax incentives, tax credits, and tax exemptions to businesses. A rational profit-seeking business will avail itself of such opportunities. In site location decisions, such

tax breaks are a deciding factor only if two or more locations are viewed essentially equally on all other factors.

Thus, state and local government tax burdens must be far out of line with competitor regions before much of an effect on the economy can be measured. For a state, a tax cut will have little effect on the economy unless the tax burden is comparatively quite high (especially versus competing states) and the tax reduction is very large. In general, tax policy is an inefficient way to stimulate the economy. Investment in infrastructure and education has been shown to have a greater effect on economic growth.

The Laffer Curve and Supply-Side Economics

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

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

The concept is simple. A single tax rate produces the greatest government revenue: the revenue-maximizing rate (RMR). Setting rates below the RMR leaves governments with less than maximum revenue but setting rates higher than the RMR stifles the economy, resulting in lower tax collections despite the higher rate. The relationship between tax rates and revenue collected follows a curve. The exact shape of the curve can vary by specific circumstances, but the end points always are the same: No tax results in no public revenue while a 100% tax rate would cause all legal economic activity to cease. The difficulties in real-world application of this relationship are to identify the tax rate that constitutes the RMR, and to describe the exact shape of the curve.

The simple concept of the Laffer curve has been lost in some applications. Some proponents of limited government erroneously argue that tax rates are always above the RMR and reduced taxation is always better.

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

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

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

For a tax cut to result in a positive effect on economic growth and government revenue, the existing tax rate must be higher than the RMR. For much of a positive effect to result, the tax rate must be very high and be lowered to near the RMR. Such a situation is most likely in the case of a narrow tax. In addition, a greater economic impact is likely from a reduction in a business tax with a rate above the RMR than in a personal tax with a high tax rate since one business decision (for example, in site selection) can affect many workers.

Value of Public Services

Over time, some supply-side enthusiasts have moved to a position that any tax cut is good for the economy and enhances public revenue—which violates the Laffer Curve. The idea that lower taxes always are better ignores the purpose of taxation.

Taxes are the price paid for a service that is publicly provided. Particularly at the state and local level, many government services directly impact the lives of all: education of children, water provision and sewer services, collection of trash, building and maintaining roads, police and fire protection, the judicial system, the correctional system, etc. Many public services, such as education (kindergarten through graduate school) and provision and maintenance of physical infrastructure, are of key importance to export businesses, particularly high-technology and other “new-economy” companies. For these types of companies, the quality of public goods is more important than the level of taxes. Thus, business climate benefits from investment in various public programs.

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

The idea that taxes remove money from the economy is false. Tax revenue is spent in much the same way as private-sector revenue: paying employees, purchasing materials from the private sector, etc. On average, a higher portion of public-sector spending is for wages and salaries while private-sector firms spend a higher portion of their revenue on raw materials and manufactured goods, much of which must be purchased from outside the region. Because of this, public-sector expenditures stay within the state’s economy to a greater extent than private-sector expenditures. In other words, the in-state multiplier effect is higher for public-sector spending than for private-sector spending.

TAXES AND ECONOMIC GROWTH IN ARIZONA

Like the nation, Arizona's economy is in the highest stage of development and must develop new technologies in order to sustain its growth. Cost factors, including taxes, are of lesser importance to interstate economic competition than in the past. Arizona's real GDP per employee in 2007 was 5% less than the national average.² While Arizona ranked seventh among nine western states, it ranked 20th among all 51 "states" (including the District of Columbia).

Conceptual Basis for the Relationship

A significant distinction exists between business taxes (discussed in Chapter 13) and personal taxes from the perspective of economic development. The distinction is blurred somewhat for very small businesses—sole proprietorships and partnerships—that file income taxes using the individual income tax. A disproportionate share of these unincorporated businesses serve the local population.

Compared to other states, Arizona's tax burden is very low on individuals (see Chapter 9), but this has little effect on the state's export sectors that drive economic growth. The tax burden on small businesses in Arizona is lower than in the average state, but the taxes paid by large businesses, especially some of the most desired export businesses, are relatively high.

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

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

Except during recessions, Arizona has had neither high unemployment rates nor high commercial/industrial vacancy rates. The majority of jobs created in Arizona are filled by labor imported into the state from other states and other countries. Thus, even assuming that tax cuts in Arizona did have an effect on economic growth, the requirement of excess capacity was not met in order for a net benefit to accrue. If lowered taxes had stimulated the Arizona economy, then even more labor would have had to have been imported into the state, both for the construction of the facilities needed to house these economic activities and for the permanent employment created. Thus, while public revenue would have increased, the

need for public spending also would have risen. Unless the incomes of the imported workers were above the existing average (considerably so if the worker had or would have school-age children), the taxes paid by new residents would not have covered the costs of providing them with public services.

Most of the taxes cut in Arizona since the early 1990s (discussed in more detail in Chapter 7) have been broad-based taxes applied to individuals. In particular, decreases in the individual income tax have accounted for nearly 60% of the cumulative \$1.6 billion nominal overall tax decrease since 1992.³ However, even in the early 1990s, the individual income tax rate in Arizona was less than the average of the states. Using the Laffer Curve, this suggests that the individual income tax cuts in Arizona should have decreased, not increased, government revenue. Conceptually, it is unlikely that these tax cuts had much of an effect on the state's economic performance.

The remaining 40% of the tax cuts since 1992 have been split between the sales tax, the residential property tax, the vehicle license tax, and the corporate income tax. Like the individual income tax, the residential property tax rate in Arizona already was relatively low, so this cut is unlikely to have had any positive effect on government revenue or economic performance.

In contrast, the general sales tax rate in Arizona is high, so the reductions in the sales tax potentially had a positive effect. Most of the revenue decline occurred in the late 1990s and was due to the reduction in the commercial lease rate and to the passage of sales tax exemptions. Similarly, the corporate income tax rate was relatively high before tax cuts were implemented in the early 2000s and again recently. Thus, while these tax rates might have generated a Laffer Curve effect, the magnitude of any benefit would be small given the very small scale of the tax cuts from the perspective of the size of all business expenses. Further, with most of these cuts occurring at a time of a booming Arizona economy, any economic stimulus created by the cuts would have resulted in an increase in the importation of labor to the state and thus a rise in government expenditures.

An example of a tax reduction that might have a more noticeable net positive effect on economic growth and public-sector finance in Arizona is the business property tax, a narrow tax that has been demonstrably high relative to other places. It is a tax that disproportionately affects some businesses, particularly manufacturers who use considerable equipment in their operation. High-tech manufacturers, such as semiconductor plants, are among those with considerable equipment. These companies pay high wages. Lower business property taxes might encourage companies to expand facilities in Arizona. Although most of the labor force needed for an expansion would be imported, the high wages of these new workers could result in a net positive effect even on public-sector finance. Fifteen years after the first tax cuts were implemented, some reduction in the business property tax currently is being phased in.

Thus, the size, nature and timing of the tax cuts in Arizona, combined with the conceptual basis for supply-side economics, suggest that little positive effect either on government revenue or on economic growth should have occurred as a result of these cuts. The next

section examines the empirical data on government revenue and economic growth to see if a positive effect of the tax cuts, or a negative effect of tax increases, is perceptible.

Empirical Evidence

In the last 30 years, Arizonans have experienced two periods of state government tax reductions and one period of tax increases. A series of significant tax law changes were made from 1979 through 1984, resulting in a significant net tax cut. Following a period of considerable tax increases from 1989 through 1991, substantial tax decreases have been passed since the early 1990s, implemented particularly from 1995 through 2001 and again in 2007 and 2008. The Arizona Joint Legislative Budget Committee (JLBC) has estimated the impact of every state government tax law change since the late 1980s.

Over the last 30 years, decreases in state taxes in Arizona generally have occurred at times of strong economic growth and budget surpluses. Tax increases have occurred at times of economic recession and budget deficits. The inverse correlation between the percentage change in economic growth and the tax change as a share of general fund expenditures is strongest when economic growth in the prior year is compared to the tax change.

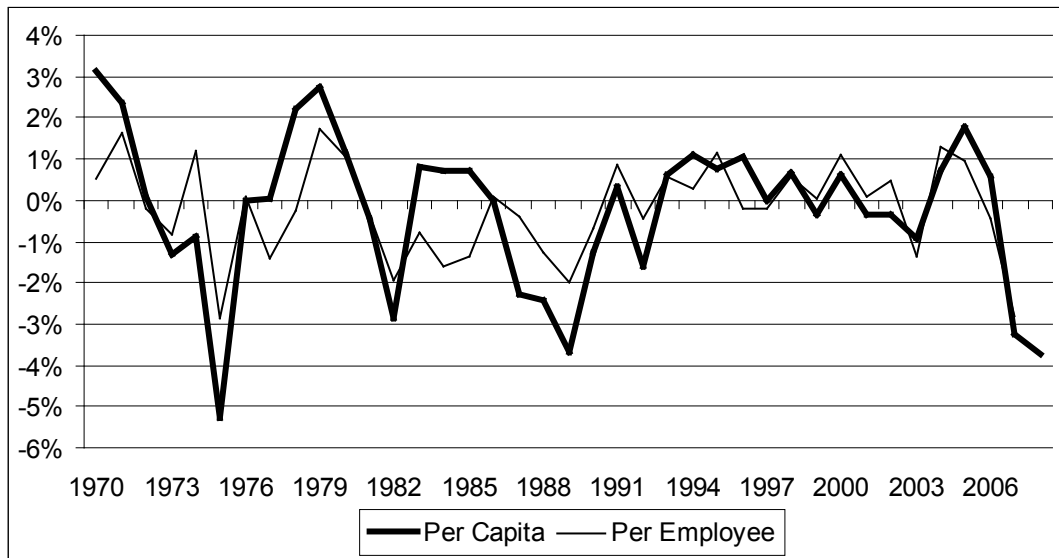
Thus, changes in economic performance slightly preceded changes in tax rates over the last 30 years in Arizona. When the economy is strong, surpluses in the general fund are realized, allowing taxes to be cut while still balancing the budget as required by the Arizona Constitution. When the economy is weak, budget deficits occur, precluding tax cuts and sometimes resulting in tax increases.

Since inflation-adjusted gross domestic product data go back only to 1990, the next-broadest measure of economic performance—the earnings component of personal income—is used to examine economic performance in Arizona relative to the national average. The history of real earnings growth in Arizona compared to the national average is presented in Figure 4.1.

Economic growth per capita and per employee in Arizona closely follows the national economic cycle. However, gains in Arizona generally are higher than the national average during periods of economic expansion, while declines are worse than the U.S. average during economic recessions. This relationship is particularly strong on the per capita measure; the per employee measure features more annual variability.

Despite the significant changes in Arizona's tax burden relative to other states since the late 1970s, economic growth in Arizona relative to the nation has not fluctuated, as seen in Figure 4.1. In particular, the substantial net tax decrease over time has not caused Arizona's economic growth in recent years to be stronger relative to the national average than in the past. Thus, the empirical evidence in Arizona regarding the lack of relationship between the state's tax cuts and increases and subsequent economic growth matches the conceptual analysis previously discussed.

Figure 4.1
The Difference Between Arizona and the United States in the Annual Percent Change in Inflation-Adjusted Earnings, 1970 Through 2008



Note: A positive figure indicates that growth in Arizona exceeded the national average.

Source: U.S. Department of Commerce, Bureau of Economic Analysis,
<http://www.bea.gov/>.

TAX CHANGES AND STATE GOVERNMENT TAX REVENUE IN ARIZONA

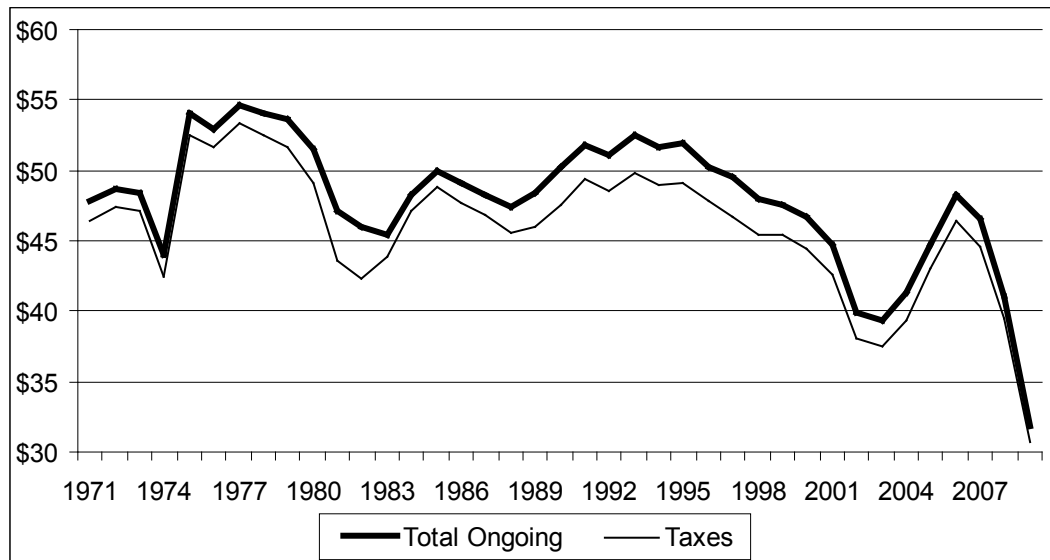
Just as an effect on economic growth from tax changes in Arizona is not perceptible, a comparison of changes in tax laws and changes in tax revenues fails to demonstrate a supply-side effect on revenues. In fact, tax cuts have resulted in revenue reductions and tax increases have boosted revenues.

Following reductions to the property tax and sales tax between fiscal years 1979 and 1981, general fund tax revenue per \$1,000 of personal income plunged, in part due to an economic recession. Despite a strong economic recovery, tax revenue per \$1,000 of personal income throughout the 1980s remained below that of the late 1970s (see Figure 4.2). As the Arizona economy weakened in the late 1980s, tax revenue per \$1,000 of personal income declined. The tax increases from fiscal years 1989 through 1991 boosted revenue, even as the economy fell into recession. Tax revenue per \$1,000 of personal income peaked in 1993 and then began to fall despite the strengthening economy and the stock market boom that caused a surge in capital gains. This countercyclical decline was the result of the long series of tax cuts passed during the 1990s. Thus, as in the 1980s, the tax cuts during the 1990s had the effect of lowering revenue, not raising it as predicted by some supply-side adherents.

Tax revenue in Arizona continued to fall through and after the 2001 recession and as capital gains turned into capital losses, bottoming out in 2003. Tax revenue per \$1,000 of personal income rose considerably during the next three years as the economy improved and capital gains returned due to the real estate boom. The 2006 peak, however, was considerably less

than the peaks of the preceding economic cycles. Since 2006, tax revenue per \$1,000 of personal income has dropped substantially to a level far below that of any of the preceding 38 years.

Figure 4.2
Ongoing Revenues Per \$1,000 of Personal Income,
Arizona State Government General Fund, Fiscal Years 1971 Through 2009



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

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¹ Much of this section is taken from Arthur Blakemore and Berthold Herrendorf, *Economic Growth: The Importance of Education and Technological Development* (January 2009), <http://wpcarey.asu.edu/seidman/Reports/P3/Blakemore.pdf>.

² U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/>. Total employment for 2008 had not been released when this report was sent to the printer.

³ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm>.

Chapter 5

CONSTITUTIONAL LIMITS ON THE POWER TO TAX IN ARIZONA

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KEY POINTS

- In general, the Arizona Constitution gives state and local governments broad taxing power.
- Although the use of the taxing power is ordinarily discretionary, the Arizona Legislature is required by the Arizona Constitution to levy taxes in order to balance the budget and to support public education.
- Property taxes in Arizona are constitutionally required to be “uniform,” but state and local governments are permitted wide latitude in subjecting different classes of property to different tax rates.
- Some kinds of property, and some property owned by veterans, widows, widowers, and the disabled, are constitutionally exempt from taxation in Arizona.
- Constitutional limits on state and local governmental expenditures, and on the amount of governmental debt that may be accumulated, indirectly serve to limit taxation in Arizona.
- The Arizona Legislature is constitutionally prohibited from imposing any net increase in state revenues unless the legislation doing so gets the affirmative votes of at least two-thirds of the members of each house of the Legislature.
- This supermajority requirement is applied to an extremely broad and inclusive definition of what constitutes a net increase in state revenues.

THE TAXING POWER

The Arizona Legislature would have the power to tax even if the Arizona Constitution were completely silent on the subject. Unlike the United States Congress, which has only the legislative powers affirmatively delegated to it by the United States Constitution, Arizona’s Legislature, like most state legislatures, needs no affirmative constitutional authorization in order to be able to exercise legislative power. The Arizona Legislature thus may levy and collect taxes however it wishes, unless prohibited from doing so by either the Arizona Constitution or the U.S. Constitution.

The power to tax is obviously among the most important—perhaps the most important—of governmental powers, since it enables governments to obtain the resources needed to fulfill their substantive responsibilities. Although they probably did not need to do so, the framers of the Arizona Constitution nevertheless included in the Constitution an express recognition of the Legislature’s taxing authority. Article 9, Section 12 of the Constitution provides, in very broad language:

“The law-making power shall have authority to provide for the levy and collection of license, franchise, gross revenue, excise, income, collateral and direct inheritance, legacy, and succession taxes, also graduated income taxes, graduated collateral and direct inheritance taxes, graduated legacy and succession taxes, stamp, registration, production, or other specific taxes.”¹

Note the specific inclusion in this list of an authority to levy several types of graduated taxes. This may have been designed by the framers to preclude an argument that provisions of the Arizona Constitution generally requiring uniform or equal treatment might be interpreted to prohibit graduated taxes, since those taxes impose different rates of taxation on taxpayers depending upon the amount of income or property that is subject to taxation. The Arizona Supreme Court has held that Article 9, Section 12 also permits excise and license taxes to be selectively levied on “certain privileges, businesses or occupations,” while “leaving others untaxed” (*Stults Eagle Drug Co. v. Luke*, 48 Ariz. 467 (1936)).

The Arizona Legislature is actually required by the Arizona Constitution to levy taxes for some purposes. Perhaps most importantly, it must do so in order to maintain a balanced budget and to pay the state’s debts. Thus, Article 9, Section 3 requires the Legislature to “provide by law for an annual tax sufficient, with other sources of revenue, to defray the necessary ordinary expenses of the state for each fiscal year.” That provision also requires the Legislature to “provide for levying an annual tax sufficient to pay the annual interest and the principal of [the state’s] debt within twenty-five years from the final passage of the law creating the debt.” Since the state’s efforts to balance the budget may not always succeed, Article 3, Section 4 also provides that, “[w]henever the expenses of any fiscal year shall exceed the income, the legislature may provide for levying a tax for the ensuing fiscal year sufficient, with other sources of income, to pay the deficiency, as well as the estimated expenses of the ensuing fiscal year.”

In addition to the balanced-budget requirement, the Constitution also expressly imposes on the Legislature the duty to levy taxes in order to support public education. Article 11, Section 1 provides that “[t]he Legislature shall enact such laws as shall provide for the establishment and maintenance of a general and uniform public school system.” That state-supported system must include “kindergarten schools,” “common schools,” “high schools,” “normal schools,” “industrial schools,” and “universities.” The latter must include “an agricultural college, a school of mines, and such other technical schools as may be essential.”

Article 11, Section 10 requires that “the legislature shall make such appropriations, to be met by taxation, as shall insure the proper maintenance of all state educational institutions, and shall make such special appropriations as shall provide for their development and improvement.” This constitutional requirement that taxes be levied in order to support public education is accompanied by an explicit constitutional ban on using the state’s taxing power to aid nonpublic schools. Article 9, Section 10 provides that “[n]o tax shall be laid or appropriation of public money made in aid of any . . . private or sectarian school.” (Section 10 also prohibits taxation in aid of “any church” or “any public service corporation.”) Taxpayers have recently invoked Section 10 to challenge the Legislature’s authorization of income tax credits to fund scholarships for students attending nonpublic elementary and

secondary schools. That case, *Green v. Garriott*, was pending before the Arizona Supreme Court at the time this chapter was written.

County and local governments in Arizona also have taxing power. Counties in Arizona have the powers that are conferred on them by the Legislature (Article 12, Sections 1–4), and the Legislature has given counties the power to “[l]evy and collect taxes for purposes under [the county’s] exclusive jurisdiction as are authorized by law” (Arizona Revised Statutes 11-201(5)).² Counties with a population of more than 500,000 (currently Maricopa and Pima) may adopt county charters (Article 12, Section 5). These county charters may authorize the county to levy and collect “taxes on a countywide basis to provide services on a countywide basis” and to levy and collect “taxes on a specially designated area basis to provide services or special levels of service to that area” (Article 12, Section 7).

Incorporated cities, towns, and villages may also “be vested by law with power to make local improvements by special assessments, or by special taxation of property benefitted,” and “all municipal corporations may be vested with authority to assess and collect taxes” for “all corporate purposes” (Article 9, Section 6). “Irrigation, power, electrical, agricultural improvement, drainage, and flood control districts, and tax levying public improvement districts” also have taxing power (Article 13, Section 7).

CONSTITUTIONAL LIMITS ON THE TAXING POWER

Article 9 of the Arizona Constitution, the Constitution’s longest article, contains most of the express limitations that the Constitution places on the taxing power of the state and its political subdivisions. The taxing power of Arizona governments is also limited by generally applicable Arizona constitutional limitations, such as the Constitution’s prohibition on local or special laws (Article 4, Part 2, Section 19), its equal protection guarantee (Article 2, Section 13), and by the equal protection clause of the U.S. Constitution. Further, the U.S. Constitution’s commerce clause has been interpreted to prohibit states from enacting taxes that discriminate against interstate commerce. All of these constitutional limitations on tax legislation apply, not only to the state’s formal legislative bodies, but also to the people, when they act through the powers of initiative or referendum that are conferred on them by Article 4, Part 1 of the Constitution.

An important general constitutional limitation on the use of the taxing power in Arizona is that “all taxes shall be uniform upon the same class of property within the territorial limits of the authority levying the tax” (Article 9, Section 1). That uniformity requirement applies only to property taxes. It was probably intended by the framers of the Arizona Constitution to be more restrictive than the equal protection guarantees of the state and U.S. constitutions, which have been interpreted to require only that legislative classifications in economic legislation have a “rational basis.” The Arizona Supreme Court has explained that Article 9, Section 1 may be more restrictive because it is “intended for a different purpose: to insure that each taxpayer’s property bear the just proportion of the property tax burden” (*In Re America West Airlines, Inc.*, 179 Ariz. 528 (1994)).

It is not clear, however, that Article 9’s uniformity requirement actually has much “bite.” Article 9, Section 1 requires uniformity within “the same class of property.” Despite this rule,

courts have given the Arizona Legislature considerable ability to establish classifications that subject similar property to different tax rates. Such classifications are struck down only when different treatment is given to property “with the same physical characteristics, used in the same industry for similar purposes.” The *America West* case, for example, struck down statutes that imposed different rates of taxation on commercial aircraft according to the number of planes owned by an airline. The result of that classification was to tax *America West*’s commuter airplanes at a higher rate than the same aircraft used by local commuter airlines, solely because the local airlines owned fewer planes. The Court explained that, on the other hand, it would be permissible to “tax small planes differently from large ones or airplanes used for rural service differently from those flying urban routes.”

The Arizona Constitution also contains a prohibition on the Legislature’s enactment of “local or special laws,” including laws that relate to the “assessment and collection of taxes” (Article 4, Part 2, Section 19(9)). Like the Article 9, Section 1 uniformity requirement, this prohibition was probably intended to be more restrictive than the requirement that all classifications have a rational basis. The local or special laws prohibition bans “inelastic” geographic and similar classifications. It would, for example, prohibit a sales-tax exemption that was applicable only to sales that took place in an area within a specified number of miles of the Mexican border (*Arizona Downs v. Arizona Horsemen’s Fund*, 130 Ariz. 550 (1981)).

A final uniformity-related provision is contained in Article 20, Section 5. Article 20 contains a number of provisions that Congress required to be included in the state Constitution at the time of its adoption. Section 5 prohibits taxation of Arizona property owned by nonresidents at a higher rate than is applicable to Arizona property owned by Arizona residents. This ban on discrimination against out-of-state owners is similar to the requirement of Article IV of the U.S. Constitution that “[t]he Citizens of each state shall be entitled to all Privileges and Immunities of Citizens in the several States.” Section 5 also prohibits Arizona from taxing Indian-owned property that is located within an Indian reservation.

In addition to the general uniformity requirement for property taxes, and the prohibition upon levying taxes to aid churches, nonpublic schools, and public service corporations, Article 9 contains a variety of specific, and often complex, provisions that limit the state’s power to tax certain kinds of property and property owned by certain classes of taxpayers:

- Section 13 prohibits taxes from being levied on “the inventory of a manufacturer . . . principally engaged in the fabrication . . . of products . . . from raw or prepared materials.”
- Section 16 exempts from property taxes noncommercial watercraft that are registered for operation in Arizona.
- Section 2 requires an exemption from property taxation for “federal, state, county and municipal property,” state, county and municipal bonds, household goods “used solely for noncommercial purposes,” and the inventories of retailers and wholesalers.
- Section 2 further provides that the Legislature may exempt from taxation “[p]roperty of educational, charitable and religious associations or institutions not used or held for profit,” “property of cemeteries” and up to \$50,000 of a taxpayer’s “personal property that is used for agricultural purposes or in a trade or business.”

- Sections 11 and 15 exempt vehicles and private aircraft registered for operation in Arizona from ad valorem property taxes, though they must pay a license tax.
- Sections 2, 2.1, and 2.2 contain constitutionally required exemptions from taxation of some property of honorably discharged servicemen and women, honorably discharged military personnel with service-connected disabilities, and permanently disabled honorably discharged personnel, as well as widows, widowers, and disabled adults who have very low incomes.

Some special constitutional rules are applicable to taxes on residential property. With some exceptions, the annual residential property tax imposed by the state “shall not exceed one percent of the property’s full cash value” (Article 9, Section 18). The same section imposes a limit, generally 10%, on the amount that the valuation of residential property for tax purposes can be increased in any single year. A limit, generally 2%, is also placed on the percentage by which the total amount of ad valorem taxes (taxes assessed according to value) imposed by a county, city, town, or community college district can be increased each year (Article 9, Section 19).

CONSTITUTIONAL LIMITS ON APPROPRIATIONS AND EXPENDITURES

An indirect, but nevertheless important, way in which the Constitution limits taxes in Arizona is through its establishment of limits on appropriations and expenditures. Article 9, Section 17 generally prohibits the Legislature from appropriating state revenues “in excess of seven percent of the total personal income of the state for each fiscal year” as annually determined by the state Economics Estimates Commission. This commission of three members chaired by the director of the Department of Revenue estimates personal income, “which estimate shall be used in computing the appropriations limit for the legislature.” Article 9, Sections 20 and 21 also require the commission to set limits on the annual expenditures of each county, city, town, community college district, and school district. These appropriations and expenditure limitations indirectly serve to limit the amount of taxes that are imposed.

The amount of taxes that can be collected in Arizona is also indirectly limited by constitutional restrictions on the amount of debt that the state and its local governments can assume. Under Article 9, Section 5, state debt “shall never exceed the sum of three hundred and fifty thousand dollars.” Article 9, Section 8 limits county and local government debt to 6% of the value of the taxable property in the governmental unit (although voters can raise the debt limit to as much as 15% of the value of taxable property for counties, and 20% of the value of taxable property for cities and towns).

CONSTITUTIONAL LIMITS ON REVENUE INCREASES

In 1992, a substantial hurdle was placed in the way of any state legislation that increases state revenues through taxation or fees, even when those taxes or fees are otherwise constitutionally permissible. At the 1992 general election, the state’s voters adopted an amendment to Article 9 that provides that state legislation “that provides for a net increase in state revenues” cannot be enacted unless it receives the affirmative votes of two-thirds of the members of each house of the Legislature (Article 9, Section 22).

Section 22 contains what appears to be an extremely broad and inclusive definition of what constitutes a “net increase in state revenues” for purposes of the supermajority requirement, although that language has not been authoritatively construed by the courts:

- “The imposition of any new tax.”
- “An increase in a tax rate or rates.”
- “A reduction or elimination of a tax deduction, exemption, exclusion, credit or other tax exemption feature in computing tax liability.”
- “An increase in a statutorily prescribed state fee or assessment or an increase in a statutorily prescribed maximum limit for an administratively set fee.”
- “The imposition of any new state fee or assessment or the authorization of any new administratively set fee.”
- “The elimination of an exemption from a statutorily prescribed state fee or assessment.”
- “A change in the allocation among the state, counties or cities of Arizona transaction privilege, severance, jet fuel and use, rental occupancy, or other taxes.”

If the governor vetoes such net-revenue-increasing legislation, a three-fourths vote in each house is required to override the veto. Revenue-increasing legislation that manages to surmount this supermajority requirement, however, goes into effect immediately, and is not subject to voter referendum (although it may subsequently be repealed or amended by voter initiative).

This supermajority requirement does not apply to net revenue increases enacted by counties, towns, cities, or other political subdivisions. An even stricter constitutional limit on the taxation of real estate transfers was passed by the electorate in November 2008. Article 9, Section 24 completely prohibits the enactment, at any level of government, of new taxes, fees or assessments on the “act or privilege of selling, purchasing, granting, assigning, transferring, receiving, or otherwise conveying any interest in real property.”

Paul Bender is a professor in the Sandra Day O’Connor College of Law at Arizona State University, teaching courses on U.S. and Arizona constitutional law. He has written extensively about constitutional law, intellectual property and Indian law, and is co-author of the two-volume casebook/treatise, *Political and Civil Rights in the United States*. Professor Bender has argued more than 20 cases before the U.S. Supreme Court, and actively participates in constitutional litigation in federal and state courts. Professor Bender served as dean of the College of Law from 1984-89, during which time he was instrumental in starting its Indian Legal Program. Prior to joining the College faculty, he was law clerk to 2nd U.S. Circuit Court of Appeals Judge Learned Hand and to U.S. Supreme Court Justice Felix Frankfurter, and spent 24 years as a faculty member at the University of Pennsylvania Law School. Professor Bender served as principal deputy solicitor general of the United States from 1993-97, with responsibility for Supreme Court and federal appellate litigation in the areas of civil rights, race and sex discrimination, freedom of speech and religion, and tort claims against the federal government. Professor Bender has served as a member of the Hopi Tribe’s Court of Appeals, and is currently chief justice of the Fort McDowell Nation Supreme Court, and the San Carlos Apache Court of Appeals. He earned his degree in law from the Harvard Law School.

¹ The Arizona Constitution is available at <http://www.azleg.gov/Constitution.asp>.

² The Arizona Revised Statutes can be accessed at <http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp>.

Chapter 6

STATE GOVERNMENT REVENUE COLLECTION: PROCESS

Georganna Meyer

Arizona Department of Revenue, Office of Economic Research & Analysis

KEY POINTS

- The Arizona Legislature adopts a budget annually for the largest state agencies and every other year for the other agencies.
- The Arizona Joint Legislative Budget Committee provides oversight of the state budget.
- The Arizona Department of Revenue collects most taxes imposed in Arizona. It is responsible for tax enforcement and collecting delinquent payments.
- The ability of the Arizona Department of Revenue to enforce tax laws has declined over time as funding for auditors and collectors has fallen while the number of taxpayers has increased.
- Income tax credits have proliferated since the early 1990s and are responsible for some of the revenue removed from the tax base.

LEGISLATIVE BUDGET PROCESS¹

The state government fiscal year runs from July 1 through June 30. The state budget is a mix of one-year budgets for the largest agencies and two-year budgets adopted in odd-numbered years for other agencies.

Shortly before the Legislature convenes in regular session each January, the governor releases a budget proposal and the Arizona Joint Legislative Budget Committee (JLBC) releases an estimate of baseline spending under existing statutory formulas and technical adjustments. The JLBC's information includes line-item detail on individual agencies.

The appropriations committees of each house of the Legislature hold hearings in January and February on individual agency budgets. The adoption of a budget includes the number of personnel, the funding level by year, the budget format (detailed lines or lump sum), footnotes (such as conditions on spending or required reporting), and performance measures.

ARIZONA JOINT LEGISLATIVE BUDGET COMMITTEE

The JLBC references two entities: the Joint Legislative Budget Committee itself and the committee staff. The JLBC is a 16-member committee responsible for oversight of all facets of the state budget, state revenues and expenditures, and future fiscal needs. It consists of eight members of each house of the Legislature, with the chairmanship rotating among the leaders of the two appropriations committees. The committee meets monthly; it has 188 statutory responsibilities. The committee provides legislative oversight of state fiscal issues especially between legislative sessions.

The legislators are assisted by the 25 nonpartisan JLBC staff members. The staff members primarily consist of analysts assigned to review the budgets of all 100+ state agencies. The staff also includes economists. A key role of the latter is to produce revenue forecasts.

The JLBC produces the baseline estimates released at the beginning of each session, provides briefing materials and analyses for the committee meetings, responds to requests from all legislators, develops cost estimates (“Fiscal Notes”) of proposed legislation as requested by any legislator (the goal is a two-week turnaround), and updates members monthly on fiscal issues by publishing “Monthly Fiscal Highlights.” This publication includes the status of revenue collection and the results of agency reports.

The Joint Committee on Capital Review (JCCR)—a 14-member committee responsible for oversight of capital projects—is comparable to the JLBC. The staff members of the JLBC support this committee as well.

ARIZONA DEPARTMENT OF REVENUE

The primary responsibility of the Arizona Department of Revenue (ADOR) is to collect taxes. The ADOR collects the transaction privilege tax (Arizona’s version of the sales tax), the individual income tax, withholding for the individual income tax, corporate income tax, liquor tax, tobacco tax, estate tax, bingo tax, flight property tax, private car tax, nuclear plan assessment tax, and waste tire tax. The ADOR also collects transaction privilege taxes imposed by all counties and by many of the cities and towns in Arizona. In fiscal year 2008, gross collections made by the ADOR exceeded \$14 billion.

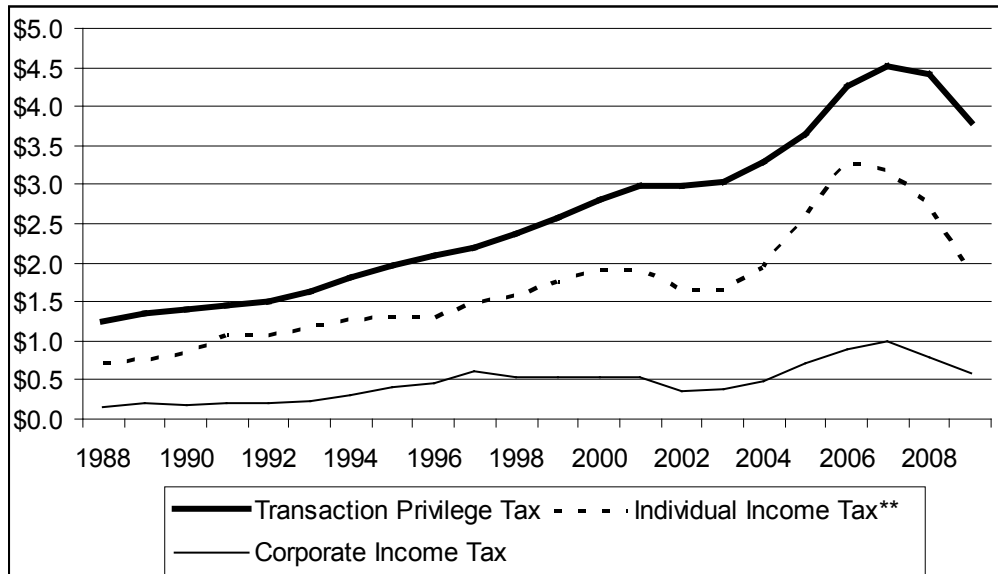
Taxes imposed in Arizona and not collected by the ADOR include:

- Fuel and vehicle taxes, collected by the Arizona Department of Transportation.
- The unemployment insurance tax, collected by the Arizona Department of Economic Security.
- The insurance premium tax, collected by the Arizona Department of Insurance.
- A few other minor taxes, collected by other agencies.

Most of the revenue is provided by the transaction privilege tax, the individual income tax, and the corporate income tax. These three taxes provide about 90% of the state general fund revenues. Although the mix of revenue varies from year to year, the average contribution by tax has been 46% of the general fund provided through the transaction privilege tax, 35% through the individual income tax, and 9% through the corporate income tax. Collections from these three taxes over the last 20 years are shown in Figure 6.1. In each of the last two recessions, revenues dropped even before considering inflation or population growth.

The process of collecting and accounting for revenue received and refunded is labor intensive but also uses a complicated computer system. Every payment that arrives is accompanied by a paper record (or a computer record when electronic filing occurs). The paper documents must be keyed and the electronic payments must pass through a processing system so that every payment is associated with some type of taxpayer identifier. All filings, whether paper or electronic, have to be checked for accuracy, from the taxpayer identification number to the simple arithmetic used on the return.

Figure 6.1
Revenues From the Three Major Taxes Unadjusted for Inflation and Population Growth, Arizona State Government General Fund, Fiscal Years 1988 Through 2009 (Dollars in Billions)



* Data for fiscal year 2009 are preliminary. ** Less urban revenue sharing.

Source: Arizona Department of Revenue.

The amount of paper or computer records that the ADOR processes annually is staggering:

- The majority of those who pay the transaction privilege tax (nearly 170,000 businesses making the sales) file monthly.
- Corporations file income taxes annually, but at least 10,000 of these taxpayers also file quarterly estimated payments. The largest taxpayers also generally file an extension when the tax is due and then file the final return six months later.
- Approximately two million individual income tax payers file annually, but again, many file quarterly estimated payments, extensions, and final returns.
- Every employer in the state must transmit its employees' income tax withholding. For the largest employers, withholding must be transmitted almost weekly.
- Luxury taxes (liquor and tobacco) are filed monthly by the distributors.
- Bingo tax is filed monthly.

Well over 5 million paper tax documents are processed by the ADOR annually. More than 1.5 million refunds were sent out in fiscal year 2008.

The ADOR is responsible for tax enforcement and collecting delinquent payments, which includes the auditing and collection functions. The ADOR also provides licensing services and taxpayer information services. One division within the ADOR is dedicated to information technology. Another division deals with property taxes. While the ADOR does not collect property taxes, it is responsible for oversight of the county assessors in the administration of Arizona's property tax laws and for the valuation of complex, geographically disbursed properties.

FACTORS AFFECTING TAX COLLECTIONS

General Fund Tax Changes

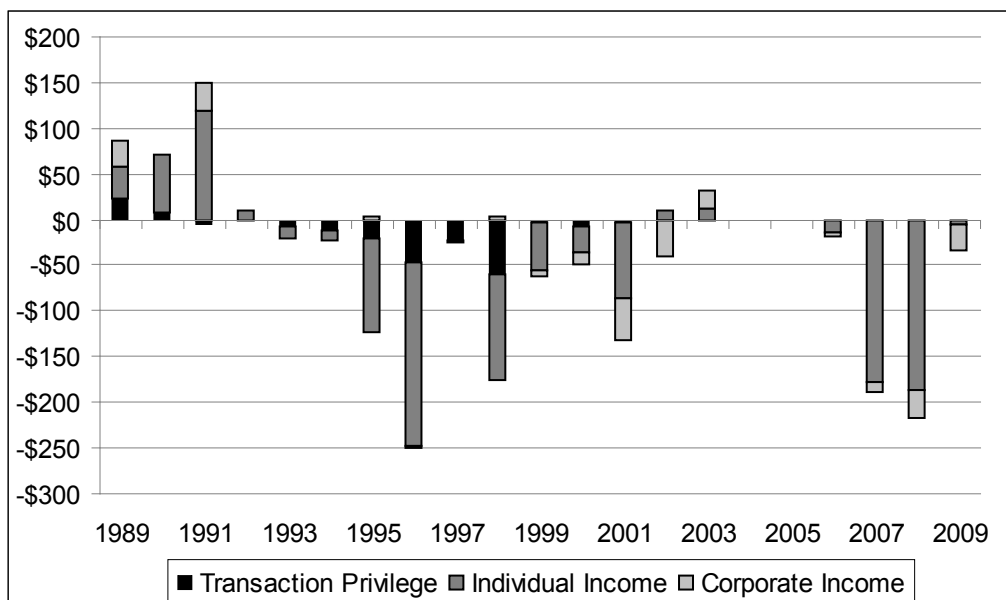
The Joint Legislative Budget Committee has estimated the dollar value of general fund tax law changes since fiscal year 1989 (see Figure 6.2). These estimates do not include the impact of voter-approved initiatives. Additionally, they are not adjusted for inflation or population growth and are static estimates, as opposed to dynamic estimates. (For example, they do not assume that a tax increase will reduce economic activity.) Taxes have been reduced in 15 of the last 17 years. The reductions in fiscal year 2009 were enacted in prior years. More detail is provided in Chapter 7.

The individual income tax has seen the greatest reduction, mostly in the form of tax rate changes. Corporate income tax reductions have included some rate reductions, apportionment ratio changes, and the implementation of additional credits.

While tax rate changes are simple for the ADOR to implement, they are not so simple for the businesses that file the transaction privilege tax. These businesses must be notified of rate changes sufficiently in advance of the rate change so that they can change their own systems.

Tax base changes are much more difficult to implement. To change the tax base of, say, the transaction privilege tax by expanding the tax to a service is not an easy task. Only businesses already subject to taxable activity, like retail, are licensed by the ADOR. Thus, for a newly taxed service, all businesses in the state offering that service have to be identified

Figure 6.2
Estimated Dollar Value of Tax Changes, Arizona State Government General Fund, Fiscal Years 1989 Through 2009 (Dollars in Millions)



Source: Arizona Joint Legislative Budget Committee.

and then licensed. Then these businesses have to be educated regarding the tax base, the process of collecting tax, and the process of filing tax returns. Imagine having to search Arizona for every dog groomer, reaching out to them personally to get them licensed and educated, gaining their cooperation in collecting the tax, and then processing their tax returns on a timely basis.

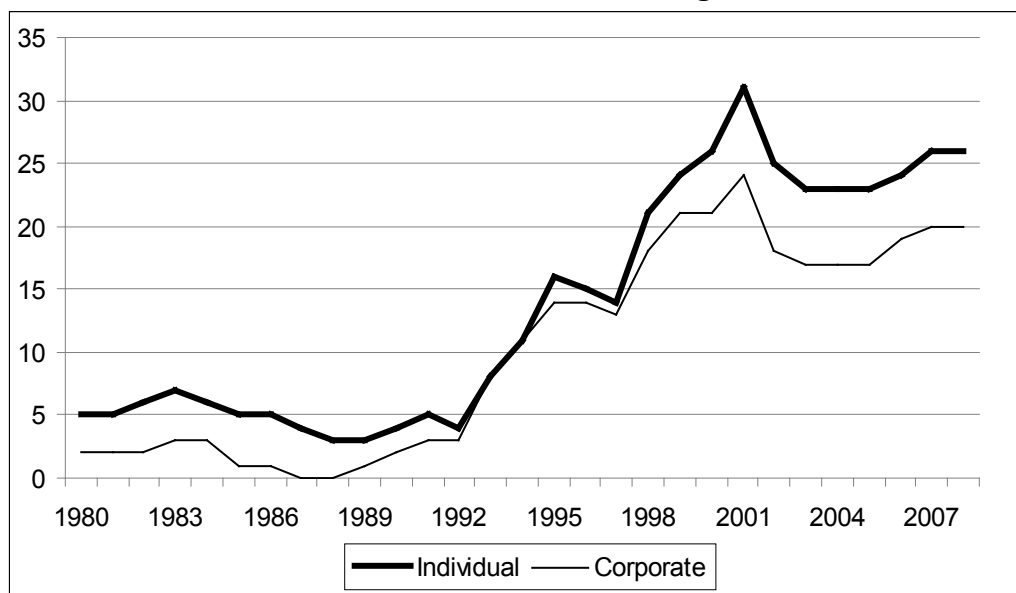
Tax Credits

A tax credit is a dollar-for-dollar reduction in individual or corporate income tax liability; it is applied *after* the tax liability is determined. This is different from deductions, subtractions, and exemptions, which reduce income *before* tax liability is calculated.

Income tax credits reduce the monies deposited to the state's general fund. The proliferation of income tax credits—both individual and corporate—has been considerable in the past 30 years. Figure 6.3 shows the count of credits available by tax year since 1980. The counts include credits that are valid for the tax year but do not include credits that can still be claimed as carry-forward amounts only.

Tax credits in Arizona can be organized into five categories. First, some credits alleviate taxes on low-income or disabled individuals. The property tax credit focuses on low-income senior citizens and blind or disabled individuals who received supplemental security income from the Social Security Administration. The broad-based family tax credit was created to exempt low-income taxpayers.

Figure 6.3
The Number of Available Individual and Corporate Income Tax Credits, Arizona, Tax Years 1980 Through 2009



Source: Arizona Department of Revenue.

Second, some credits were created to enhance economic development. Most of the following credits were created either for a specific corporation or for a specific location:

- Defense contracting credit
- Enterprise zone credit
- Environmental technology credit
- Military reuse zone credit
- Motion picture production credit
- Research and development credit

The exception is the research and development credit, which was intended to attract and retain corporations with extensive research and development activities. (Since nearly all other states offer some type of research and development tax credit, this credit is needed to maintain a certain level of competitiveness.)

A new economic development credit was signed into law at the end of the 2009 regular legislative session: the renewable energy incentive credit. It was passed to lure solar equipment manufacturers to Arizona.

A third group of tax credits address environmental concerns. Some kind of environmentally responsible behavior is encouraged by offering these tax credits:

- Agricultural pollution control equipment credit
- Agricultural water conservation system credit
- Commercial and industrial solar credit
- Healthy forest credit
- Pollution control device credit
- Solar credit
- Solar hot water heater plumbing stub-outs/electric vehicle outlets
- Water conservation credit

Tax credits in the fourth group are behavioral in nature. The goal is to encourage a certain behavior other than those related to economic development or the environment. These credits either do not benefit the donor directly or they try to encourage the taxpayer to behave in a certain manner, such as to hire a specific category of people:

- Contributions to charities that provide assistance to the working poor
- Employment of National Guard members
- Employment of TANF (Temporary Assistance for Needy Families) recipients
- Investment in small business credit
- Private school tuition organization credit
- Public school extracurricular activity credit
- School site donation credit
- Taxes paid for coal consumed in generating electricity

Another of these credits was recently signed into law after the second special legislative session of 2009. The new credit is for corporate donations to school tuition organizations to pay for scholarships for disabled and displaced students.

The remaining tax credits exist for various reasons. The income tax credit for taxes paid to other states or countries exists for taxation equity. The Clean Elections credit and the credit for increased excise taxes paid are the result of voter initiatives.

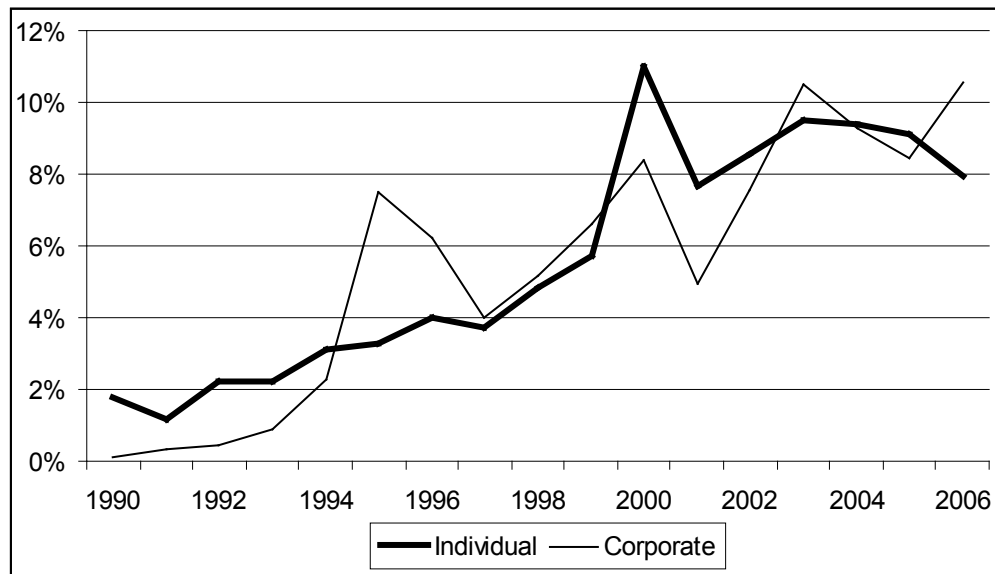
Figure 6.4 presents the dollar value of individual and corporate income tax credits as a proportion of the tax liability. These data do not include available credit carry forward. (Credit carry forward is credit established in a certain tax year but because insufficient tax liability was available in that tax year to use the credit, the credit was carried forward to future years.) The spike in 2000 was the result of the alternative-fuel vehicle credit, which was claimed by far more taxpayers than anticipated.

Data on the effect of each tax credit is difficult to provide. For example, of the 25 individual income tax credits that could be claimed in 2005 (whether as original credits or carry-forward only credits), seven had no claims and two credits had so few taxpayer claims that the ADOR cannot release any information as to the cost of these credits. Of the 20 corporate income tax credits that could be claimed in 2005 (original or carry forward), five had no claims and four had so few taxpayer claims that the cost of the credit could not be released.

Audit and Collection Staff Positions at the Arizona Department of Revenue

The enforcement of the tax laws and the amount of taxes collected through the enforcement process are directly related to the number of auditors and collectors at the Arizona Department of Revenue. The auditor and collector staffing level depends on the ADOR budget, as determined by the Arizona Legislature.

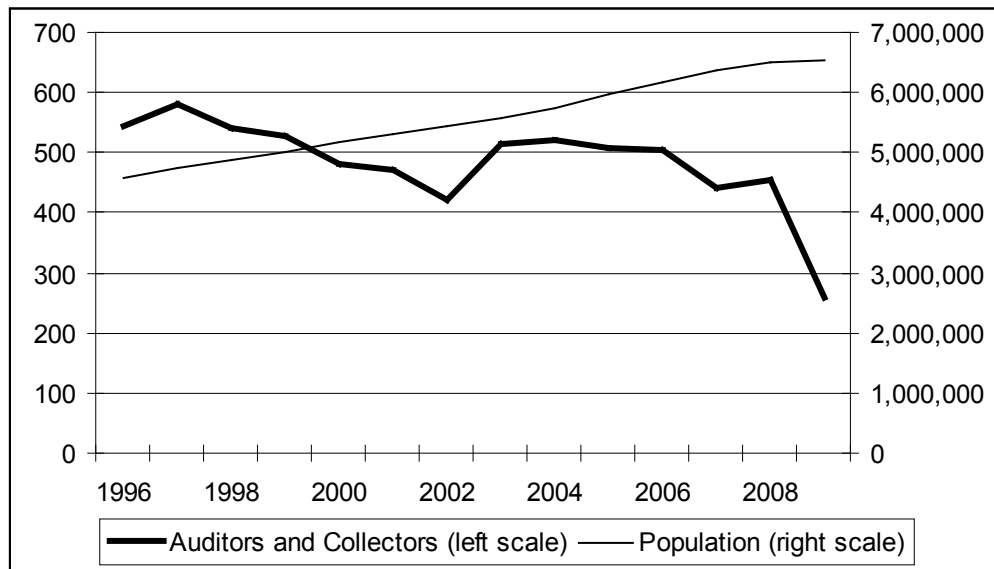
Figure 6.4
Individual and Corporate Income Tax Credits as a Share of Tax Liability, Arizona, Tax Years 1990 Through 2006



Source: Arizona Department of Revenue.

Figure 6.5 shows the number of audit and collection positions compared to the number of Arizona residents. While the state's population continued to climb through fiscal year 2008, reaching 6.5 million, the number of filled auditor and collector positions at the Arizona Department of Revenue declined from nearly 600 in fiscal year 1997 to below 500 in fiscal year 2008. The result was an increase from 8,139 to 14,286 Arizona residents per auditor or collector. In the spring of 2009, due to revenue shortfalls, the Arizona Department of Revenue budget was significantly reduced. As a result, the number of audit/collection staff members has declined to 258. Assuming modest growth in population in 2009, there is now one auditor/collector position per 25,388 residents.

Figure 6.5
Number of Auditors and Collectors at the Arizona Department of Revenue
Relative to the Arizona Population, Fiscal Years 1996 Through 2009



Source: Arizona Department of Revenue.

Georganna Meyer, chief economist at the Arizona Department of Revenue, has been with the department since 1984, holding the chief economist position since 1986. She holds a bachelor's degree from Emporia State University in Kansas and a Master of Business Administration from the University of Kansas. Her Office of Economic Research and Analysis analyzes tax collection trends, forecasts revenue, prepares fiscal notes on proposed tax legislation, staffs three commissions, publishes a variety of statistical information, and performs various administrative functions for the Department of Revenue. Former president of the Arizona Economic Round Table, the Western States Economic Summit, and the Federation of Tax Administrator's Tax Research and Revenue Forecasting Section, she has been active in the economic community for 25 years.

¹ This and the following section were taken from a presentation to new legislators produced by the Arizona Joint Legislative Budget Committee, *New Legislator Orientation* (December 10, 2008), <http://www.azleg.gov/jlbc/newlegislatororientation.pdf>.

Chapter 7

STATE GOVERNMENT REVENUE: HISTORICAL RECORD

Tom R. Rex

Arizona State University, Center for Competitiveness and Prosperity Research

KEY POINTS

- State government general fund revenue is highly cyclical. Total ongoing revenue reached \$9.5 billion in 2007, but was only \$6.9 billion in 2009.
- Compared to the size of the Arizona economy, ongoing general fund revenue has fallen since the early 1990s, with the figure for the last year the lowest on record.
- The decline in ongoing general fund revenue results from a series of tax cuts passed since the early 1990s that have cumulated to \$1.6 billion in nominal terms and to \$2.6 billion after adjusting for population growth and inflation.
- 90% of ongoing general fund revenue comes from two highly cyclical sources: the sales and use tax and the income tax. In the past, the general fund received monies from a more extensive list of sources, some of which provided more stable revenue.
- State government utilizes a number of funds other than the general fund. Most are small, with revenue coming from specialized sources. The highway user revenue fund is the largest, with more than \$1.3 billion in annual revenue in recent years.

INTRODUCTION

As was noted in Chapter 2, the initial budget for all of Arizona state government in fiscal year 2009 was \$28.1 billion, but less than half of this amount (\$13.1 billion) was appropriated by the Legislature. Most of the remainder originated from the federal government and was designated for specific uses, with the actual spending often made by local governments. Thus, this chapter is limited to the revenue raised by state government and appropriated by the Legislature.

Arizona state government operates numerous funds. Most are small, receive their revenue from narrow sources, and are greatly restricted in how the monies are spent. In contrast, not only is the general fund much larger, but its revenue comes from multiple sources and is expended for multiple uses. The Legislature has considerable discretion over the general fund, which is the primary focus of this chapter.

Ongoing revenue is reported in this chapter. This excludes revenue transferred to the general fund from other funds. Such transfers were significant in 2009. The original general fund appropriation was nearly \$10 billion. In mid-year, it was reduced to \$9.4 billion. But ongoing revenue ended up totaling less than \$7 billion.

This chapter relies on state government revenue data from the Arizona Joint Legislative Budget Committee (JLBC).¹ It focuses on the last fiscal year (2009), which ran from July 1,

2008 through June 30, 2009. However, some of the detailed reports from the JLBC for 2009 were not yet available when this report was sent to the printer. Unless otherwise noted, years referred to in this chapter are fiscal years.

The general fund as defined by the JLBC is different from the general revenues and expenditures defined by the U.S. Census Bureau (discussed in Chapter 9). Other than utility and insurance trust funds, the Census Bureau groups Arizona's many funds into its "general" category. See Appendix 2 for more detail regarding the data and the measures used to analyze the data.

GENERAL FUND ONGOING REVENUE

State government general fund ongoing revenue per \$1,000 of personal income since 1971 is displayed in Figure 4.2. The bulk of the revenue comes from tax collections. The lines plotted in the chart illustrate considerable cyclicity in revenue corresponding to the economic cycle. The lines also fluctuate due to changes made to the tax code.

Revenue per \$1,000 of personal income has declined from the peak level of the mid-to-late 1970s, with most of the decrease occurring since the early 1990s. The decrease in revenue from the early 1990s through 2000 occurred during a long period of strong economic growth and resulted from a series of tax decreases passed by the Arizona Legislature, as detailed in the following subsection. In contrast, the further decline in revenue from 2001 through 2003 was due to a weak economy. The sharp increase in revenue in 2005 and 2006 reflects a strong economy that was boosted by the real estate boom. The large downturn in revenue from 2007 through 2009 (the last year on the chart) is partially due to further tax cuts, but also results from the severe economic recession that began late in calendar year 2007. Ongoing revenue per \$1,000 of personal income in 2009 was by far the lowest figure on record.

History of Tax Law Changes

Significant changes to the Arizona tax code have been implemented over the last 30 years. Tax collections were reduced significantly between 1979 and 1981. Decreases in property tax rates caused collections to drop in 1979 and 1980, and the sales tax on food to be consumed at home was eliminated in 1981. At the same time that substantial reductions in revenue resulted from these changes, an economic slump also lowered general fund revenue. The result was a significant imbalance between revenue and expenditures that was solved by a combination of spending reductions and a temporary increase in the sales tax rate. Even with a strong economic recovery that began in 1983, the budget could not be balanced without maintaining the higher general sales tax rate. Thus, this higher rate was made permanent in 1984. Despite this rate increase, tax collections per \$1,000 of personal income remained below the levels of the late 1970s, as shown in Figure 4.2.

In the mid-1980s, few changes were made to the tax code. After 1986, the state economy weakened substantially, lowering general fund revenue. At the same time, spending skyrocketed for the Arizona Health Care Cost Containment System (AHCCCS, the state's alternative to Medicaid). Prior to the mid-1980s, spending on indigent health care was a county, not state, responsibility.

In order to annually balance the general fund, as required by the Arizona Constitution, tax increases and spending reductions were implemented from 1989 through 1991. Collections were increased from various taxes, most notably the individual income tax. Expressed as a percentage of the general fund, the effects of the tax law changes were large from 1989 through 1991, raising revenue at least 3.6 percent in each of the three years. Despite a weak economy through 1992, tax collections rose. The JLBC estimated that the effect of these tax increases was to raise state government revenue by nearly \$450 million per year by 1992 (see Table 7.1).

After 1992, the Arizona economy began to strengthen, causing a cyclical recovery in revenue to begin. The budget surpluses resulting from the improving economy enabled a series of tax cuts to be passed. The magnitudes of the initial cuts were small and/or the reductions were phased in due to revenue collection still being weak and continued spending increases for AHCCCS. The Arizona economy strengthened further during 1994, with growth rates

Table 7.1
Estimated Dollar Value of Tax Changes, Arizona State Government
General Fund, Fiscal Years 1989 Through 2009

Fiscal Year	Tax Change in Millions		
	Annual	Cumulative Since 1988	Cumulative Since 1992
1989	\$122	\$122	
1990	109	231	
1991	208	439	
1992	10	449	
1993	-19	430	\$-19
1994	-25	405	-44
1995	-121	284	-165
1996	-285	-1	-450
1997	-175	-176	-625
1998	-172	-348	-797
1999	-142	-490	-939
2000	-105	-595	-1,044
2001	-158	-753	-1,202
2002	-33	-786	-1,235
2003	12	-774	-1,223
2004	57	-717	-1,166
2005	-5	-722	-1,171
2006	-18	-740	-1,189
2007	-194	-934	-1,383
2008	-218	-1,152	-1,601
2009	-35	-1,187	-1,636
2009, Adjusted*		-1,377	-2,579

* Adjusted for inflation and population growth

Sources: Arizona Joint Legislative Budget Committee (tax changes) and U.S. Department of Commerce, Census Bureau (population) and Bureau of Economic Analysis (gross national product implicit price deflator).

reaching boom conditions in 1995. The cyclical surge in revenue that resulted allowed subsequent tax reductions to be much larger. Between 1995 and 2001, the decreases in revenue ranged from 1.8 to 6.5 percent of the size of the general fund. The tax increases of 1989 through 1992 were reversed by 1996 on a nominal basis, by 1997 on a real basis, and by 1998 on a real per capita basis.

Tax reductions continued through 2001. Thus, despite the strong economic cycle and the surge in capital gains due to the stock market boom, revenue per \$1,000 of personal income decreased substantially from 1995 through 2001.

An economic recession in 2001 followed by a weak and slow recovery held down state revenue for years, precluding new tax reductions of any magnitude to be implemented between 2002 and 2006. However, strong economic gains eventually returned, boosted by the real estate boom. The resulting budget surpluses created the opportunity to pass additional tax cuts that largely took effect in 2007 and 2008. The tax cuts amounted to about 2 percent of the size of the general fund in each of those years. The effects of the business property tax reductions that were passed in 2005 and currently are being phased in are not included in the JLBC's estimates of effects of the tax law changes.

The loss in general fund revenue since 1992 cumulates to \$1.6 billion. If inflation and population growth are considered, the magnitude of the net tax cuts since 1992 balloons to nearly \$2.6 billion per year.

The historical record indicates that most of the tax cuts occurred at times of strong economic growth when surplus funds were available (actual revenue collected exceeded projections and exceeded the amount spent). Further, the sizes of the surpluses were unusually large from the mid-1990s through 2000 due to the boom in the stock market, which caused capital gains to soar, boosting state tax collections. Surpluses again were very large from 2005 through 2007 and again were due to a surge in capital gains, this time the result primarily of the real estate boom. Capital gains probably dropped substantially in calendar year 2008, contributing to the decline in state government revenue in fiscal years 2008 and 2009.

Tax Law Changes by Type of Tax

The individual income tax was disproportionately affected by the changes in tax laws, with revenue declines from this tax accounting for nearly 60% of the cumulative total since 1992. A series of individual income tax rate reductions were implemented, with significant declines in revenue in 1995 and 1996, from 1998 through 2001, and again in 2007 and 2008 (see Figure 6.2).

Property tax cuts occurred primarily in 1997, when the statewide property tax was eliminated. The cumulative reduction in sales tax collections was due primarily to a phased-in reduction in the commercial lease rate implemented from 1994 through 1998. A variety of other sales tax exemptions also were added to the tax code. (The voter-approved increase in the sales tax rate in 2000 did not affect the general fund, since the revenue was earmarked for education.) The first decrease in corporate income taxes did not take effect until 2000. It was not until 2001 that the corporate income tax increases of 1989 and 1991 were offset. The

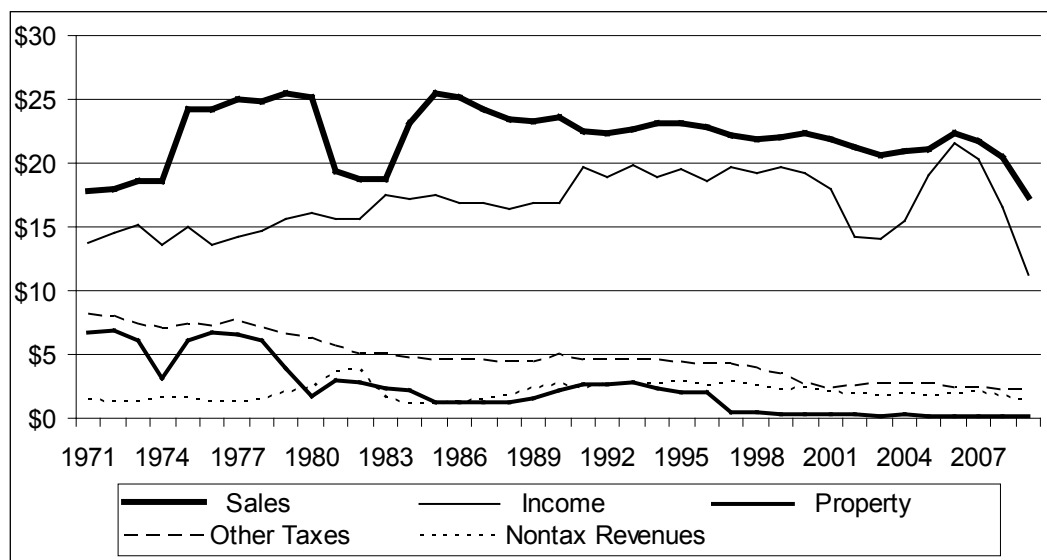
cumulative decreases in collections since 1992 from the sales, property, and corporate income taxes have been similar in magnitude. The net decline in other taxes entirely results from the elimination of the general fund portion of the vehicle license tax between 1999 and 2001.

Tax collections by type per \$1,000 of personal income are shown in Figure 7.1. The decline since the 1970s in state government general fund revenue per \$1,000 of personal income displayed in Figure 4.2 primarily results from significant decreases in revenue per \$1,000 of personal income from the property tax and from taxes other than property, income, and sales. Revenue from the sales tax also has dropped. In contrast, relative to personal income, income tax collections (which include personal and corporate) increased except for sharply lower figures during the last two economic downturns.

That income tax collections held steady during the 1990s and briefly surged from 2004 through 2006 despite the multiple decreases in rates is not a result of “supply-side” economics. Instead, sharp increases in capital gains—due to the stock market boom in the 1990s and to the real estate boom from 2004 to 2006—are responsible for the strong income tax collections during those years. The surge in income tax collections during the 1990s and again a few years ago occurred throughout the country, regardless of whether state income tax rates were increased or decreased.

As a result of the numerous tax changes over the years, Arizona’s state government general fund has experienced a sharp redistribution in revenue sources over the last few decades. Of

Figure 7.1
Revenue by Type Per \$1,000 of Personal Income, Arizona State Government General Fund, Fiscal Years 1971 Through 2009

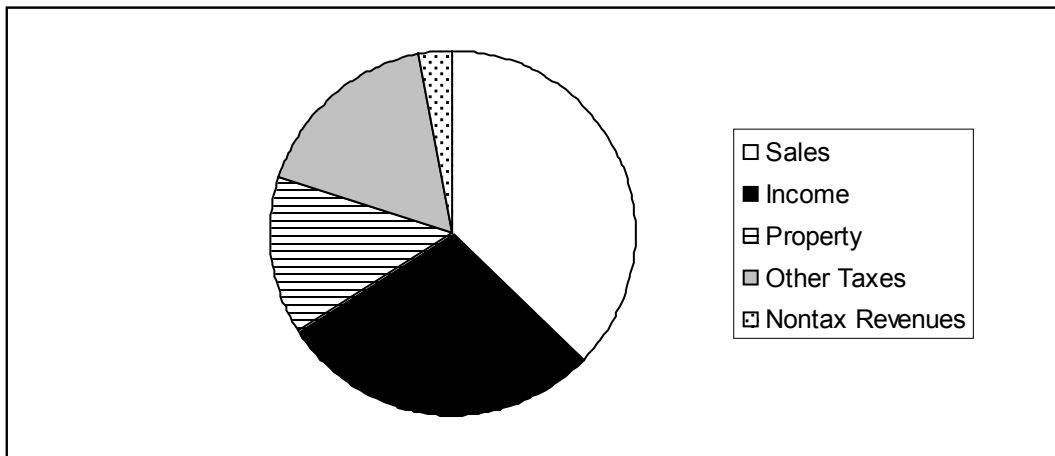


Sources: Arizona Joint Legislative Budget Committee (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

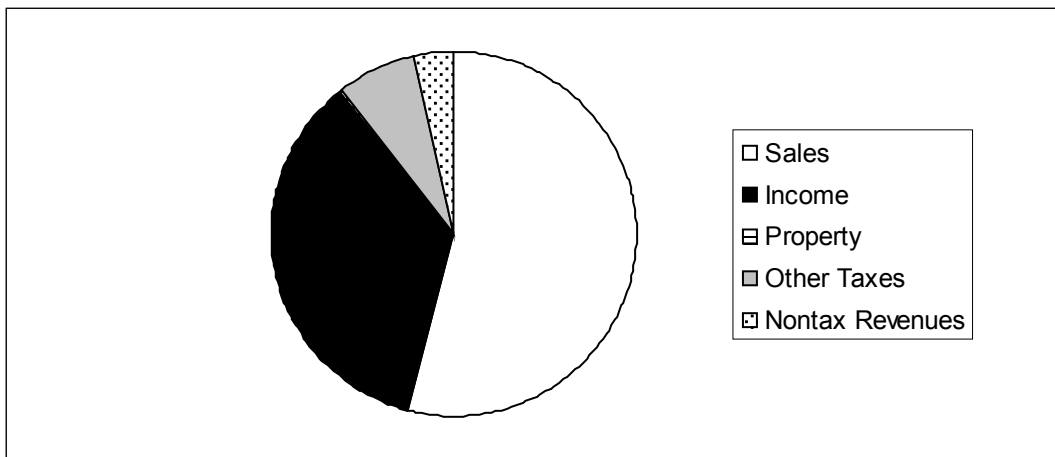
particular note is the decline in general fund revenue from the property tax, culminating in the state general fund portion of the property tax for all practical purposes being eliminated in 1997. In addition, sales tax rates have increased while reductions in personal income tax rates have been implemented. Miscellaneous other revenue sources contribute much less to the general fund than in the past; for example, funds from the vehicle license tax no longer are applied to the general fund.

The result is displayed in Figure 7.2. In fiscal year 1971, the first year of consistent general fund data, the sales and income taxes accounted for 65% of general fund revenue. In recent years, the share has been 90%. So, instead of a three-legged stool accounting for relatively equal shares of the majority of revenues, the general fund is very heavily dependent on just two highly volatile taxes.

Figure 7.2
Sources of Arizona State Government General Fund Revenue
Fiscal Year 1971



Fiscal Year 2009



Source: Arizona Joint Legislative Budget Committee.

Revenue Sources

Ongoing revenue to the state government general fund was approximately \$6.9 billion in 2009—\$1.8 billion less than in the prior year and \$2.6 billion less than the peak figure of \$9.5 billion in 2007. The two-year decline is 27%—before considering inflation or population growth. Revenue from almost all sources declined in 2008 and 2009.

The general fund receives revenue from a number of tax and nontax sources, as seen in Table 7.2. However, just two taxes—the sales and use tax and the individual income tax—provided almost 90% of the revenue in 2009, compared to 65% in 1971.

Sales and Use Tax

The general fund's primary revenue source is sales and use taxes, accounting for more than half of the total general fund revenue. In 2009, sales and use tax collections were \$3.76 billion, down near \$600 million from the prior year and \$700 million from 2007.

Sales and use tax collections per \$1,000 of personal income peaked at more than \$25 in 1985, about equal to the 1979 figure, but have since declined, to less than \$18 in 2009. Despite this decrease, the sales and use tax share of total revenue collections has increased from less than 37% in the early 1970s to more than 50%.

A number of taxes comprise the sales and use category. By far the largest component of the sales and use category is the transaction privilege tax (TPT)—Arizona's version of a general sales tax in which the seller is responsible for remitting the entire amount of the tax due to the state. Though the overall state tax rate is 5.6%, 0.6% is dedicated to education; these

Table 7.2
Ongoing Revenue by Source,
Arizona State Government General Fund, Fiscal Year 2009

	2009 Preliminary (In Millions)	Share of Total
TOTAL ONGOING REVENUE	\$6,933	100.0%
Total Taxes	6,679	96.3
Sales and Use	3,756	54.2
Total Income	2,432	35.1
Individual	2,568	37.0
Corporation	592	8.5
Urban Revenue Sharing	-728	-10.5
Property	18	0.3
Luxury	59	0.8
Insurance Premium	411	5.9
Estate	0	0.0
Other Taxes	1	0.0
Nontax Revenues	255	3.7
Lottery	31	0.4
Interest	20	0.3
Other	204	3.0

Source: Arizona Joint Legislative Budget Committee.

monies do not enter the general fund. In 2008, nearly \$4 billion in revenue to the general fund was collected from the TPT. The retail portion of the TPT accounted for 46% of the collections, with the contracting tax's share around 22%, and the utilities and restaurant/bar subcategories each contributing 8%. A variety of other TPT taxes made up the remaining 16% of the general sales tax collections.

The use tax, which contributed \$341 million in general fund revenue in 2008, is applied to retail purchases of personal property by Arizona businesses in states that levy a sales tax of less than 5.6%. (Individuals also are subject to this tax, but enforcement of this provision is limited.) Other sales and use tax sources—severance tax on metalliferous minerals, jet fuel use tax, jet fuel excise tax, severance tax on timber, and rental occupancy tax—provided only \$25 million in general fund revenue.

Income Tax

The income tax is the other primary source of general fund revenue: its share dropped to 35% of the total in 2009. The net collection from the individual and corporate income tax less the amount distributed to local governments through urban revenue sharing was \$2.4 billion, down \$1.1 billion from the prior year and \$1.7 billion from 2007. Before the urban revenue sharing distribution, collections from the individual income tax totaled \$2.6 billion in 2009, compared to \$592 million from the corporate income tax. Collections from the individual income tax fell more than \$800 million in 2009 and nearly \$1.2 billion over two years. Collections from the corporate income tax were down \$217 million in 2009 and \$394 million over two years.

Collections from the corporate income tax always have been cyclical, but the volatility in individual income tax collections has increased substantially since the mid-1990s, due to the huge cycles in capital gains. After accounting for less than 30% of total general fund revenue through most of the 1970s, the income tax share has fluctuated since then from 30-to-45%.

Income tax collections per \$1,000 of personal income in recent years have ranged from nearly \$20 during the late 1990s to \$14 in 2003 to nearly \$22 in 2006, the highest on record. The 2008 figure was less than \$17 and the 2009 figure was only \$11—the lowest in the 39-year time series.

Property Tax

In the 1970s, the property tax was the third largest source of state general fund revenue, with collections amounting to more than \$6 per \$1,000 of personal income. A large tax cut in 1980 dropped this figure to less than \$2, and the elimination of the state portion of the tax in 1997 cut general fund collections to just \$0.1 per \$1,000 of personal income in 2009. The \$18 million deposited into the state general fund in 2009 came from land parcels not included in a school district. Property taxes still are collected by local governments and are a major source of revenue for school districts.

Other Taxes

A variety of other taxes combined to contribute \$471 million in 2009, close to 7% of the state's general fund revenue. Collections were marginally higher than in 2007 and 2008

(before adjustment for inflation and population growth). In the early 1970s, these other taxes accounted for nearly 17% of the general fund total. Per \$1,000 of personal income, collections have fallen from more than \$8 to a little more than \$2. Other than the insurance premium tax—which now accounts for most of the collections (\$411 million in 2009) in this category—the other tax sources have declined in importance. After collections of around \$1.3 per \$1,000 of personal income through most of the time series, the insurance premium tax figure increased in 2003 and 2004 to about \$1.9.

Per \$1,000 of personal income, luxury tax collections were around \$4 in the early 1970s but now are only \$0.3, estate taxes have dropped from \$1.1 to virtually zero, the pari-mutuel tax dropped from \$0.5 to zero, the motor vehicle license tax fell from around \$1 to zero, and all other taxes combined declined from \$0.5 to barely more than zero.

Nontax Revenue

Various other sources of revenue contributed \$255 million, or 3.7%, of the general fund total in 2009. The state lottery added \$318 million to the general fund. Interest earned dropped sharply to \$20 million. These nontax revenues per \$1,000 of personal income had been near \$2 since the late 1980s, but the 2009 figure was only \$1.2.

OTHER FUNDS

State government utilizes a number of funds other than the general fund. Most of these funds—such as the emergency telecommunications services revolving fund, state aviation fund, underground storage tank revolving fund, and utility regulation revolving fund—are relatively small (less than \$100 million in annual revenue). These funds derive their revenue from specialized sources and are used for specific purposes.

The highway user revenue fund, in contrast, has received more than \$1.3 billion in revenue in recent years. It has multiple revenue sources, with the largest being the motor vehicle fuel tax, the vehicle license tax, and the use (diesel) fuel tax. The unemployment compensation fund has had funding of just more than \$300 million in recent years.

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¹ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm>.

Chapter 8

LOCAL GOVERNMENT REVENUE COLLECTION: PROCESS

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KEY POINTS

- Local government in Arizona consists of large entities such as cities, towns, counties, and school districts, as well as literally hundreds of small, limited-purpose local governments, each with taxing authority.
- State law prescribes strict standards in the way local governments prepare, discuss, and adopt budgets and tax rates.
- Sales taxes and property taxes are the major locally imposed revenue sources. Property taxes are constitutionally limited and can only be adopted or increased by a vote of the people. County sales tax authority is limited by state law.
- The state imposes an expenditure limitation on municipal and county governments. This limitation may be modified by a vote of the electorate.
- Revenue collected by the state and shared with cities, towns, and counties constitutes a major portion of local government budgets and provides stable revenue, particularly to small and rural communities.

INTRODUCTION

Local government in Arizona consists of counties, cities and towns, school districts (including community colleges), and special districts of various types. The 2007 Census of Governments counted 645 local governments operating in the state, each with its own elected governing board, various levels of taxing and regulatory authority, and operating budgets financed by taxpayers. On a per capita basis, the number of local governments in Arizona is only a third of the national average.

Cities and towns—general-purpose governments—are the primary focus of this chapter. Counties are briefly discussed later in the chapter. These entities are governed by constitutional and statutory provisions regarding the raising of local revenue for their operations.

A budget is primarily a statement of community priorities. Through their local elected officials, residents of cities and towns determine the level at which they choose to be taxed and the uses for which those funds will be put.

Cities and towns are statutorily required to do only three functions: maintain streets and roads, provide for public safety (police services), and establish an administrative center of government to provide citizens with access to their local government officials. All other purposes are statutorily optional, but many are perceived as mandatory by citizens and local

officials. These include fire department services, parks and recreation, water and wastewater treatment, planning and zoning, senior centers, etc. The amount of money raised in total revenue, its various sources, and the way it is distributed among these many public purposes is the subject of numerous public hearings and council decisions.

REVENUE SOURCES

Cities and towns in Arizona may use the following local revenue sources for general government purposes: sales tax (transaction privilege tax), property tax (with voter approval), use tax, bed tax, business license tax, franchise taxes, and municipal court fines. Various kinds of fees are charged for specific services and typically are designated to make certain kinds of services self-sustaining, such as fees for water, sewer, and garbage services. These are also called enterprise funds.

Cities and towns may also charge development impact fees on a per-unit basis in order to pay for necessary public infrastructure associated with new growth and development. In most cases, impact fees do not cover the entire expense of new infrastructure, but they offset a portion of the cost in an effort to “make growth pay for itself” and to avoid taxing existing residents repeatedly to pay for infrastructure needs they did not cause.

Additionally, cities and towns may issue bonds for the construction of public infrastructure upon a positive vote by the people. The primary kinds are general obligation bonds and revenue bonds. General obligation bonds are backed by the full faith and credit of the municipality; revenue bonds are to be paid back by a stream of local revenue generated by the public facility being constructed with the bond proceeds.

Arizona cities and towns also share a portion of the income and sales taxes collected by state government. As a result of several voter-approved initiatives in the 1940s and 1970s, cities and towns receive 15% of state income tax collections and 25% of a limited sales tax base. These funds are distributed on a per capita basis, except in the case of the shared income tax where the smallest six towns receive a distribution as if they had a population of 1,500. Shares of the state gasoline and vehicle license taxes also are distributed to cities and towns for transportation purposes. However, this fund has been “swept” (dramatically reduced) by the Arizona Legislature in recent years to help balance the state general fund.

Some state government policymakers dislike the fact that a portion of some state tax proceeds are distributed to cities and towns (and counties). Yet, state government places significant limitations on the types and amounts of revenue that may be collected by local governments.

ENACTMENT REQUIREMENTS AND LIMITATIONS

Property Tax

The property tax is a traditional means of financing city and town services. While the importance of the property tax has been decreasing in recent years due to increased revenue from sales taxes, it still is an important source of local revenue for many Arizona cities and

towns. The property tax has also been one of the most stable sources of revenue, because it is not as subject to the cyclical fluctuations experienced by sales taxes.

Beginning with the 1980 tax year, property tax levies were divided into a primary property tax and a secondary property tax. A secondary property tax may only be levied to pay the principal and interest charges on bonds. The primary property tax levy is for all other purposes. There are no limits on the amount of secondary property taxes, while there are strict constitutional limits placed on the primary property tax. About half of cities and towns impose a primary property tax; most of them make use of the secondary property tax.

The primary tax levy is limited to an increase of 2% over the previous year's maximum allowable primary levy, plus an increased dollar amount due to a net gain in property not taxed the previous year. In November 2006, voters elected to reset the "base year" from which annual levy increases are calculated from fiscal year 1979-80 to 2005-06.

The 2% increase is based on a city or town's "maximum allowable levy" for the prior year. That is, even if a municipality does not adopt the maximum allowable levy from year to year, the 2% allowable increase will be based on the prior year's "maximum allowable levy" anyway. The "net new property" factor is included in the calculation to take into account all new construction and any additional property added to a community due to an annexation.

The total primary property tax for homeowners from all taxing jurisdictions may not exceed 1% of the home's primary assessed value. If the combined tax exceeds 1% of the primary assessed value, the school districts reduce their tax rate until the homeowners' aggregate rate is equal to or less than the allowable 1%. State government subsidizes the school districts for the reduced revenue. This 1% limitation does not apply to the secondary property tax levy.

The secondary property tax allows a city or town to levy a property tax for the purpose of retiring the principal and interest on bonded indebtedness. Not only is the dollar amount of the secondary property tax levy "unlimited," the actual full cash value of property is used in determining the tax rate. This is unlike the primary tax system, which uses a controlled assessment system to determine the tax rate for primary property tax purposes. The bottom line on the secondary property tax system is that a city or town can levy the amount necessary to pay off its debt service.

Any city or town that wants to initiate a primary property tax must submit the proposed amount to be raised from the tax to the voters at an election to be held on the third Tuesday in May. The amount approved by the voters will constitute the base on which future limitations on levies will be determined. If the voters approve the levy, the city or town council may levy the tax in the fiscal year immediately following the election. The city or town, however, is not required to levy the entire amount approved by the voters in the first year.

A city or town that incorporates or annexes land must give proper notice before levying a property tax in the next fiscal year. The Property Tax Oversight Commission was formed in 1988 to review the primary property tax levy limitations of each city, town, county, and community college district in the state.

Sales Tax (Transaction Privilege Tax)

Arizona's "sales tax" technically is a transaction privilege tax imposed on the seller of goods who is ultimately responsible for paying the tax on items sold. The tax is levied on retail sales and a number of other activities, such as contracting.

In addition to the state tax rate of 5.6%, municipalities may levy an additional tax rate. A city or town may establish a local sales tax through adoption of an ordinance. The initiation of this tax does not have to be submitted to a vote of the people in the community. However, there are 19 charter cities with charter provisions requiring voter approval to increase the sales tax above a specified limit. A charter city is one in which the governing system has been defined by the city's own charter (comparable to a constitution) rather than as prescribed by state statute.

In recent years, the local sales tax, as a means of financing municipal services, has been increasing in importance. All incorporated cities and towns levy a local sales tax. The statewide average is 2.25%; rates range from 1.5–4%.

All of the cities and towns in the state have adopted the Model City Tax Code, which provides a degree of uniformity across communities, while allowing cities and towns to determine their own sales tax base. The Municipal Tax Code Commission was created by the Arizona Legislature during the 1988 legislative session to act as a forum for discussion of all changes to the Model City Tax Code. The League of Arizona Cities and Towns staffs the Municipal Tax Code Commission and maintains changes and updates to the Model City Tax Code. This system provides multijurisdictional taxpayers a single point of contact for the sales tax practices of all 90 incorporated cities and towns.

Development Impact Fees

The principle of impact fees is that "new growth pays for itself." Charges are imposed on new residential and commercial construction projects based on the impact those developments have on local necessary public infrastructure. The definition of "necessary public infrastructure" differs from community to community depending on local standards and preferences.

The process for adopting municipal impact fees is long and complicated, requiring a city to first identify all its infrastructure projects in an infrastructure improvements plan. Then a study must be done by a professional consultant to determine the amount of impact of new developments on that public infrastructure. A city or town council may then propose impact fees that collect a proportional amount from homebuilders or developers for their share of the infrastructure costs. With all the statutorily required public hearings and waiting periods, it takes nearly a year for a city to implement a new impact fee structure. The authorization and process for county development fees is almost identical to that for cities and towns.

State law is clear that monies collected from impact fees must be used to serve new development, not to provide enhanced services to other parts of the city. Impact fees must be spent on infrastructure only, not on salaries or general operating costs. Depending on their

size, some cities have different infrastructure districts within their corporate limits while others consider their service area to be the entire community.

Other Taxes and Fees

Other taxes such as use tax, bed tax, franchise tax, and business license tax contribute relatively small amounts to total municipal revenue and are often more regulatory in nature. Fees charged for various utility functions such as water, sewer, and garbage services account for large dollar volumes, but are not available for general fund use. Rather, a fee is imposed for a specific service and the proceeds from that fee are used to operate and maintain that particular service. These kinds of “enterprise funds” tend to operate as entrepreneurial businesses within the structure of city government and are generally self-sustaining.

STATE BUDGET LAW REQUIREMENTS

While the general concept behind the budgetary process in a city or town is relatively simple, there are a number of requirements in Arizona state law that adds complexity to this process.

Funds

A fund within a municipal budget is a sum of money set aside as a separate and independent fiscal and accounting mechanism. State law requires only two budgetary funds; however, additional budgetary funds may be created.

First, a city or town must have what is commonly called a “general fund.” State statute stipulates that each city or town “prepare a full and complete statement of the financial affairs of such political subdivision for the preceding fiscal year and an estimate of the different amounts which will be required to meet the public expense of each such political subdivision for the current fiscal year.”

The second fund which each city and town in the state of Arizona must establish is the “highway user revenue fund.” The monies which go into this fund are collected by the state from the tax on the sale of gasoline and diesel fuels and from other transportation-related fees. State government passes a certain amount of this revenue on to cities and towns. The expenditure of highway user revenue is limited to projects within the public right of way.

Cities and towns may choose to establish other funds depending on the priorities of each individual community. For example, these could include a library or utility fund. If bonds are outstanding, certain funds may be required by the council-approved bond resolution, and there are also special requirements for improvement districts.

State-Imposed Expenditure Limitation

Provisions of the state-imposed expenditure limitation appear in the Arizona Constitution and the Arizona Revised Statutes. The constitution sets forth in some detail the framework of the expenditure limit and the remaining details are provided in state law.

The Economic Estimates Commission (EEC) determines each year just how much each city and town can increase its budget for the next fiscal year under the state-imposed limit. This determination is made on the basis of a standard increase in inflation and the population

growth of the particular community. The inflation increase is measured by the gross domestic product implicit price deflator produced by the U.S. Bureau of Economic Analysis. Population figures to be used in the calculation are supplied by the Arizona Department of Economic Security. The population in annexed areas is considered when developing the population estimate that is used in determining the expenditure limitations by the EEC, as well as for distribution of lottery funds.

State law requires that the EEC provide each city and town with a preliminary estimated expenditure limit for the coming fiscal year by February 1, and a final expenditure limit figure by April 1. If the estimate received by February 1 is felt to be inaccurate for any reason, a city may appeal to the EEC for an adjustment.

The state-imposed limitation uses actual payments of local revenues for fiscal year 1979-80 as the base limit. The Economic Estimates Commission has determined this base limit for every city and town based on information supplied by each community in 1980. This base consists of those expenditures “controlled” by the state limitation and does not include those revenues specifically exempted from the limitation or involuntary tort judgments.

Expenditure Limitation Options

If the estimated state-imposed limit appears to be correct but does not allow for the expenditure of sufficient funds to meet local needs, the budget law provides four options to potentially solve this problem: local home rule, a permanent base adjustment, a capital projects accumulation fund, and a one-time override. All of these options require voter approval. Most cities and towns (77 of 90) have adopted some form of alternative expenditure limitations, with the most common choice being the home-rule option that allows voters to re-visit spending levels every four years

Home Rule (Alternative Expenditure Limitation)

Any city or town can adopt its own “alternative” expenditure limitation that is free from any ties to the state-imposed limitation if a majority of the qualified electors voting on the issue at a city/town regular election vote in favor of the alternative limitation. An alternative limitation may be referred to city/town voters by an affirmative vote of two-thirds of the members of the city/town council or by qualified electors of the city/town offering an alternative limitation through the initiative process.

The city or town council contemplating the adoption of an alternative expenditure limitation must follow a detailed procedure that includes posting notices of public hearings, holding the hearings, voting on the proposed alternative expenditure limitation, publishing the alternative in a newspaper of general circulation, submitting a detailed analysis and summary of the alternative to the Auditor General, providing a publicity pamphlet to each household within the city or town containing a registered voter, etc.

When an alternative expenditure limitation is adopted it will be in effect for four consecutive years. Following the fourth year, the alternative must be “reapproved” or a new alternative may be proposed. Each city or town must repeat the detailed procedure involving the Auditor General, publications, election, etc. every four years whether they are “reaffirming” a

previously approved alternative limitation or adopting a new one. If the alternative limitation is defeated by a majority of the qualified electors, no new alternative expenditure limitation may be submitted to the voters for at least two years, and the city/town will be subject to the state limitation.

Permanent Adjustment of Expenditure Base

Any city or town can permanently adjust its state-imposed expenditure limitation base if a majority of the qualified electors voting on the issue at a regular city or town election or at a state general election vote in favor of the adjustment. A base adjustment may be referred to the voters by an affirmative vote of two-thirds of the members of the city or town council, or qualified electors of the city/town may propose an adjustment through the initiative process.

The city or town council is required to pass a resolution on the proposed permanent base adjustment in an open meeting, a detailed analysis and summary of the adjustment must be submitted to the Auditor General for review, a publicity pamphlet must be provided to each household within the city or town containing a registered voter, etc. Any approved permanent base limitation adjustment must be used in determining the expenditure limitation beginning with the fiscal year immediately following the approval and every year thereafter or until the city/town again adopts a new base.

Capital Projects Accumulation Fund

The only specific reference to establishing a capital projects accumulation fund is located in the Arizona Constitution. This option was used in communities where the state expenditure limit was sufficient except in the area of capital outlays. While still statutorily permitted, this option has become functionally obsolete in light of the availability of other capital financing mechanisms.

One-Time Override

Any city or town may exceed its state-imposed expenditure limitation by a one-time override. This override is effective for one year only and has no effect on the expenditure limitation base or any subsequent fiscal year expenditure limitation.

The one-time override can be sought if two-thirds of the members of the city/town council vote to present the proposed override to the qualified electors of the city or town. A majority of qualified electors voting at either a special election (to be held the third Tuesday in May) or at a regular election in the fiscal year prior to the fiscal year in which the override is to occur must give their approval in order to expend the additional amount. Public hearings, newspaper notices, and a voter publicity pamphlet are requirements as in the other options.

State law requires that expenditures for amounts authorized by an override election can only be made for purposes stated in the publicity pamphlet for such an election. Expenditures approved pursuant to a one-time override election have to be budgeted separately.

Preparation of a Budget

The preparation of a municipal budget is a long and detailed process. The council and staff generally have to set a number of administrative deadlines to make sure that the budget has

been given full consideration prior to its final adoption. State law specifies a number of dates with which a city or town must comply when preparing a budget.

Developing the Budget

The budget process is initiated by obtaining accurate estimates of incoming revenues. Estimates of projected state-shared revenues for the upcoming fiscal year are usually provided in lump sum figures from the state departments actually distributing the funds. If the estimates are made available in a reasonable amount of time prior to the preparation of the budget, the League of Arizona Cities and Towns will publish an estimate of revenues going to each city and town from the state sales tax, the state income tax, the highway user revenue fund, and the local transportation assistance fund. Estimates on the amount of vehicle license tax revenues must be obtained from the appropriate county government.

Estimates of revenues raised from local sources have to be developed by each city or town. Some municipalities prepare a budget report on a regular basis throughout the fiscal year which gives an up-to-date comparison of incoming revenues and expenditures. This type of document is one of the most useful monitoring tools for detecting any trends in collection totals which might affect revenues during the upcoming year. Monitoring is particularly helpful for the local sales tax, building permits, and other revenue sources that are highly dependent on economic conditions. Since revenue estimates that turn out to be too generous can come back to haunt city and town administrators, estimates must be reasonably accurate or even conservative.

Once the finance officer is confident of the revenue estimates, the next step is to analyze the anticipated expenditures for the upcoming year. These estimates should have been developed in the budget preparation phase and are based on some of the following considerations:

- The variety, type, and level of services that the city or town wants to provide, including the maintenance or abandonment of current programs as well as the initiation of any new services. This is an area where the city or town council should play a significant role.
- Known cost factors include such items as social security costs, contribution rates to employee pension and retirement funds, workers' compensation rates, and announced postal rate increases.
- A fairly comprehensive price list should be developed for anticipated costs on items in the general category of supplies and contractual services, including costs for any anticipated major capital expenditures. These costs tend to be especially susceptible to inflation.
- The cost of employee salaries typically is the largest expenditure in the city or town budget. Therefore, careful attention is given to any cost-of-living or merit increases or any other major changes in the employees' salary schedule.
- Insurance costs have been steadily increasing for city and town governments.
- Changes in employee fringe benefits include any changes affecting vacation policy, overtime, holidays, uniform allowances, health insurance, and sick leave.
- General economic fluctuations are one of the most difficult considerations when preparing a budget. The most sophisticated economists have difficulty predicting cyclical swings in the economy. While economic fluctuations cannot be predicted

accurately, administrators are keenly aware of the potential impact of general economic conditions on the local budget. Also, any local events—such as large layoffs at a major employer or businesses opening or closing—that significantly impact on the local economy must be taken into consideration.

Once all anticipated expenditures have been taken into consideration, the problem then becomes adjusting the expenditures to the available revenue. This process may involve cutting some expenditure appropriations while expanding others. Again, this is a policy area where the city or town council must provide active leadership.

Budget Adoption

State law requires that on or before the third Monday in July of each fiscal year, the city or town council must adopt a tentative budget. Once this tentative budget has been adopted, expenditures may not be increased but they may be decreased. The tentative budget must be fully itemized in conformance with forms supplied by the Auditor General and entered into the council meeting minutes. The tentative budget must be published once a week for at least two consecutive weeks following the adoption.

No specific date is set by state law for adoption of the final budget. However, the property tax levy must be adopted by the third Monday in August. Since state law requires a period of at least 14 days between adoption of the final budget and adoption of the tax levy, the deadline becomes the first Monday in August. For cities and towns without a property tax, it is still recommended that final budget adoption take place by mid-August. The adoption of the final budget may take place through a simple motion approved by the council.

Arizona state law stipulates that no expenditures may be made for a purpose not authorized in the annual budget. This makes it extremely important for the budget to be closely monitored to ensure that expenditures do not exceed the amount budgeted.

Generally speaking, budget item expenditures may not exceed the amount indicated in the final adopted budget. However, if a situation arises that necessitates the transfer of funds between budget items, state law provides authorization for such transfers. Thus, state law allows cities and towns to exceed expenditures in a budget item after final adoption of a city/town budget.

Adoption of Property Tax Levy

The county assessor provides property value information each year to each municipality. Using this information, the council must specify the amount of the property tax levy to be assessed in the next fiscal year. If the proposed primary tax levy, excluding amounts attributable to new construction, is greater than the amount levied by the city or town in the previous year, the council must publish a notice that meets various requirements, schedule a public hearing, and fulfill other requirements in accordance with the truth-in-taxation law. If a city or town fails to comply with the notice and hearing requirements, then in the upcoming year the jurisdiction is prohibited from levying more than was levied in the prior year.

The tax levy ordinance does not require a three-fourths vote or an extraordinary vote to make the levy effective because this is an administrative matter and not an act of legislation. This determination is based on a Arizona Supreme Court decision in which the court ruled that the state's general appropriation bill was not legislation, but merely an administrative method of setting apart funds necessary for use and maintenance of state government. This case also applies to the municipal budgetary process.

Any money received in excess of the maximum allowable limit must be maintained in a separate fund and be used to reduce the primary property tax levy in the following year. However, additional amounts collected from escaped property and monies that are received from the payment of delinquent property taxes properly assessed in prior years are exempted from this requirement. Escaped properties are those parcels which did not appear on the assessment rolls for the tax year, but which would have appeared if they had been identified.

Any affected political subdivision, including cities and towns, must include in their budgets for the next fiscal year the proportional amount of any property tax refund for which they are liable when the refund is for overpayment as a result of a change in the tax roll pursuant to state statute authorizing such change.

Audits

State law requires an audit of municipal operations to be made by a certified public accountant or a public accountant currently licensed by the Arizona State Board of Accountancy. The audit is required each fiscal year for cities and at least once every two fiscal years for towns.

The audit, as required by the uniform expenditure reporting system and Arizona law, must include a financial statement of all accounts and funds of the municipality. Audits must be conducted in accordance with generally accepted auditing standards. The audit report must include the professional opinion of the auditor regarding the financial statements of the city or town, or a declaration of why such an opinion cannot be expressed.

The audit report must include a "determination" that highway user revenue fund monies and other dedicated state transportation revenues received by the city/town were used solely for the authorized purposes. The Auditor General's office requires that the auditor specifically report this determination in the auditor's opinion on the financial statements or a separate report of the auditor within the city/town's audit report.

COUNTIES

Like municipalities, Arizona's 15 counties are political subdivisions of the state and must abide by revenue and expenditure constraints and processes. There are, however, some important nuances.

Counties serve as administrative arms of state government, implementing state law and providing state-mandated services in a regionally efficient manner. Counties fund and operate superior and justice courts; provide probation services; manage regional jail facilities; enforce state health, safety, and environmental standards; and provide general

government services, such as document recordation, property valuation, and tax collection on behalf of all local jurisdictions. Counties also provide some city-type services—such as planning and zoning, and public safety—for residents of unincorporated areas.

Counties have four main revenue sources for general fund purposes. County officials have limited or no flexibility over these resources, as each is restricted by the Arizona Constitution or state law. As with all jurisdictions, the annual growth of county primary property tax collections is capped at 2% plus revenues from any new construction. Counties receive a statutorily prescribed share of revenues associated with state transaction privilege tax and vehicle license taxes. Counties, except Maricopa, have authority to assess a ½-cent sales tax for general fund purposes; 13 levy this tax, with 12 of the rates at 0.5%. In some counties, voters have approved additional sales taxes dedicated to specific purposes. Four levy a sales tax for roads at 0.5% and six have a sales tax for jail facilities (ranging from 0.2–0.5%). One collects a 0.125% sales tax for capital purposes and two counties assess a 0.1% sales tax for health-related activities. The overall county sales tax rate ranges from 0.25–1.125%.

It is important to note that county officials have little control over major cost drivers and state-mandated expenditures. For example, the implementation of the state criminal code determines the number of people in county jails and in county probation programs. Also, certain cost-sharing arrangements prescribed by state law are outside of county managerial control, most notably those associated with the statewide court system and the Arizona Long-term Care System, managed as part of the Arizona Health Care Cost Containment System. State policy regarding implementation and funding of these programs has a direct consequence on county expenditures.

SCHOOL DISTRICTS AND SPECIAL DISTRICTS

The 2007 census counted 239 regular school districts, plus 14 systems dependent on another level of government in Arizona. (The state also has more than 500 public charter schools.) The school districts rely primarily on local property taxes and direct appropriations from state government. Generally, the same kinds of property tax processes and restrictions apply to them that apply to cities and towns. These entities have a different relationship with the state government, however.

Public education is considered a state responsibility and various constitutional and statutory requirements apply to the operations of public schools, which receive direct appropriations from state government. School districts do not impose any kind of transaction tax.

According to the 2007 Census of Governments, 301 special districts operated in Arizona. Half of these were fire districts and 20% were irrigation districts. Other districts also have been created for other single purposes such as hospitals, electric power, and sewer and flood control. Each has an elected governing board that is subject to the same budget, open-meeting, and public-records requirements as all other levels of local government. Virtually all special districts receive their operating revenues from property taxes. They are generally found in unincorporated areas and are created by a vote of the people for a specific single purpose.

In addition, a number of special districts have been created within cities and counties for neighborhood improvements such as street paving or lighting. In those cases, the elected officials who created the district also serve as its governing board. Community facilities districts are another kind of special taxing district that pays for the installation of certain infrastructure within planned development communities.

RELATIONSHIPS BETWEEN LEVELS OF GOVERNMENT

Local government taxes are neither collected nor spent in isolation. A great deal of overlap and a series of complex, symbiotic relationships exist across local governments. Certain kinds of special districts—fire, hospital, irrigation, etc.—may overlap with portions of towns or counties providing some of those same services. Residents who do not have children attending school are subject to school property taxes and reap the benefits of having an educated work force. People who live in incorporated cities and towns do not have their county taxes reduced even though they do not receive the patrol services of the county sheriff.

Local governments must be sensitive to a “tipping point” at which taxpayers no longer feel that their tax burden is proportionate to the level of services they receive. In states such as California, Colorado, and Oregon, citizen initiatives have severely restricted local property taxes. Starting with Proposition 13 in California, activist groups have successfully used the argument that property taxes disproportionately impact the low-income elderly, and have been able to restrict property tax rates and to place limits on annual increases.

Conventional wisdom also says that once the combined state and local sales tax rate crosses 10%—the “double digit barrier”—citizens will resist further increases and may attempt to roll back rates. Since local governments have the lowest threshold for signature gathering for a citizens’ initiative, it is likely they would be hit first under such a scenario.

Clearly, the revenue collection process at the local government level in Arizona must be coordinated and harmonized with those of other local taxing districts and the state government. The citizens of Arizona are the ones ultimately paying taxes regardless of the levying authority, and they are the ones who are due the benefit of services supported by state and local taxes.

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Chapter 9

LOCAL GOVERNMENT AND COMBINED STATE AND LOCAL GOVERNMENT REVENUE: HISTORICAL RECORD

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KEY POINTS

- Local governments in Arizona receive a higher proportion of their revenue from transfers from the state government and from the sales tax, and relatively little from user fees, relative to the national average.
- State and local government revenue in Arizona—per capita and relative to personal income—is much below the national average, and is further below average than in the past.
- While funding from the federal government is near normal, own-source tax revenues and user fees are considerably below average in Arizona.
- Arizona governments collect relatively little tax revenue from most sources, but much more than average from the sales tax.
- Various studies of tax burden agree that Arizona ranks considerably below the national average.

SOURCES OF LOCAL GOVERNMENT REVENUE

The primary source of data on public-sector finance across the United States is the government finance series compiled by the U.S. Department of Commerce, Census Bureau.¹ These data are described in Appendix 2, which also discusses the measures used in this chapter to analyze the data.

Of the total revenue realized by local governments in Arizona, a higher-than-average proportion comes from utility revenue. Focusing on what the Census Bureau terms general revenue, the total received by local governments in Arizona in fiscal year 2006 was \$21.9 billion. (Subsequent references to years in this chapter refer to the fiscal year that runs from July 1 through June 30.)

Intergovernmental revenue to local governments in Arizona—transfers from the federal and, especially, state governments—accounted for an above-average share at 42%. The national average was 38%. The remaining revenue is termed “own-source revenue,” consisting of local taxes, user fees, and other sources. The Arizona Legislature limits the sources of local government revenue; for example, local governments in Arizona cannot levy an income tax.

As a share of total general revenue of local governments in 2006, taxes and user fees (the Census Bureau calls user fees “current charges”) each made up a below-average share of the

total in Arizona. Other revenues, such as interest earned, accounted for an average share in Arizona.

While taxes made up a below-average share of total general revenue, taxes accounted for an average share (64%) of local government own-source revenue in Arizona in 2006. Most of the tax revenue (and more than 40% of all own-source revenue) came from the property tax, though these shares were less than the national average. The general sales tax provided most of the remaining tax revenue in Arizona. The general sales tax in Arizona accounted for more than twice as large a share of both total general revenue and own-source revenue than the national average.

User fees accounted for less than one-fourth of own-source revenue in Arizona, a share less than the national average. In particular, housing and community development fees were quite low in Arizona.

Compared to the national average, local governments in Arizona are unusually dependent on two sources of revenue: the general sales tax and funds transferred to them from the state and federal governments. The property tax represents the largest single source of revenue.

COMBINED STATE AND LOCAL GOVERNMENT REVENUE

Total state and local government general revenue in Arizona was \$36.5 billion in 2006: \$6,021 per resident and \$190.41 per \$1,000 of personal income. Total revenue was less than the national average, by 18.1% per capita and by 7.5% per \$1,000 of personal income. Arizona's per capita figure was second lowest in the nation. Arizona ranked 39th among the 51 "states" (including the District of Columbia) on the personal income measure. Between 1992 and 2006, Arizona's rank dropped from 36th to 50th per capita and from 26th to 39th based on personal income. (The year 1992 was selected for comparison since it is a census year and because it represents the beginning of the period of ongoing tax reductions by the Arizona Legislature.)

Given the questions regarding the accuracy of the 2006 Census Bureau data for Arizona, data for 2005 also were examined. General revenue per capita in Arizona was 16% below average in 2005, third lowest among the 51 states; general revenue per \$1,000 of personal income was 4% below average, ranking 35th. Thus, while Arizona revenue in 2006 was comparatively lower than in 2005, the conclusion is the same: Arizona governments received less revenue than their national counterparts.

Intergovernmental transfers from the federal government amounted to \$8.8 billion in 2006, nearly one-fourth of Arizona state and local government revenue (see Table 9.1). Per capita receipts from the federal government were 4% below the national average, with Arizona ranking 31st among all states. However, receipts per \$1,000 of personal income were 8% above average after having been 7% below average in 1992. Arizona's national rank on federal funds relative to personal income rose from 38th to 26th. Arizona experienced an increase in federal funds much above the national norm from 1992 through 2006, based on both measures (per capita and per \$1,000 of personal income).

Table 9.1
General Revenue in Arizona by Source,
Combined State and Local Government, Fiscal Year 2006

	Dollars in Thousands	Share of Total	Per Capita		Per \$1,000 of Personal Income	
			Dollars	Ratio to US	Dollars	Ratio to US
TOTAL REVENUE	\$36,482,885	100.0%	\$6,021	81.9%	\$190.41	92.5%
From Federal Government	8,818,173	24.2	1,455	95.7	46.02	108.1
Total Own Source	27,664,712	75.8	4,566	78.3	144.39	88.4
Taxes	19,940,354	54.7	3,291	81.9	104.07	92.4
Property	5,524,045	15.1	912	75.5	28.83	85.2
Sales and Gross Receipts	9,347,395	25.6	1,543	111.3	48.79	125.7
General Sales	7,463,355	20.5	1,232	129.8	38.95	146.6
Selective Sales	1,884,040	5.2	311	71.2	9.83	80.3
Motor Fuels	772,849	2.1	128	102.6	4.03	115.8
Alcoholic Beverages	61,147	0.2	10	55.9	0.32	63.1
Tobacco Products	298,001	0.8	49	97.7	1.56	110.3
Public Utilities	183,726	0.5	30	38.1	0.96	43.0
Other	568,317	1.6	94	57.0	2.97	64.3
Individual Income	3,253,279	8.9	537	59.4	16.98	67.1
Corporate Income	890,004	2.4	147	82.5	4.65	93.2
Motor Vehicle License	192,171	0.5	32	46.0	1.00	51.9
Other	733,460	2.0	121	43.9	3.83	49.6
Nontax Sources	7,724,358	21.2	1,275	70.4	40.32	79.5
Current Charges	4,418,044	12.1	729	64.7	23.06	73.1
Education	1,682,879	4.6	278	85.2	8.78	96.2
Higher Education	1,437,224	3.9	237	85.9	7.50	97.0
School Lunch Sales	111,501	0.3	18	81.1	0.58	91.6
Other	515,185	1.4	85	30.2	2.69	34.1
Hospitals	19,689	0.1	3	5.9	0.10	6.7
Highways	334,184	0.9	55	106.0	1.74	119.7
Airports	8,037	0.0	1	23.6	0.04	26.6
Parking Facilities	0	0.0	0	0.0	0.00	0.0
Natural Resources	121,192	0.3	20	167.6	0.63	189.3
Parks and Recreation	119,993	0.3	20	68.0	0.63	76.8
Housing and Community Development	33,004	0.1	5	31.9	0.17	36.0
Sewerage	533,040	1.5	88	77.4	2.78	87.4
Solid Waste Management	363,922	1.0	60	131.0	1.90	147.9
Other	686,919	1.9	113	64.3	3.59	72.6
Miscellaneous Revenue	3,306,314	9.1	546	79.7	17.26	89.9
Interest Earned	1,169,245	3.2	193	80.3	6.10	90.6
Special Assessments	75,854	0.2	13	52.5	0.40	59.2
Sale of Property	324,506	0.9	54	404.0	1.69	456.2
Other	1,736,709	4.8	287	70.3	9.06	79.4

Source: U.S. Department of Commerce, Census Bureau (revenue and population) and Bureau of Economic Analysis (personal income).

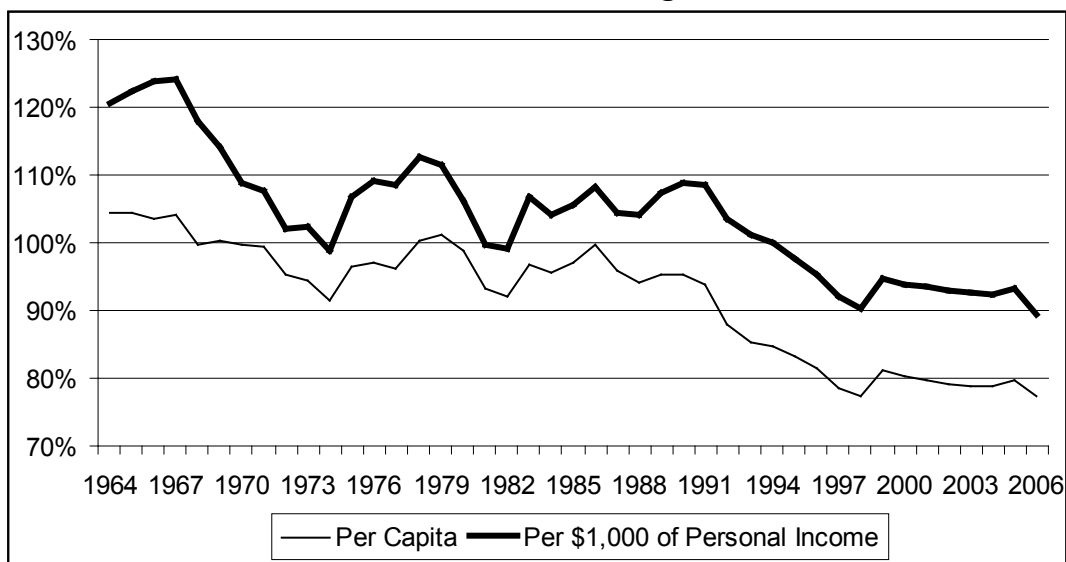
Own-source revenue totaled \$27.7 billion in Arizona in 2006, accounting for 76% of all revenue. On a per capita basis, this amounted to \$4,566—22% less than the U.S. average, ranking 47th in the nation. Per \$1,000 of personal income, Arizona was 12% below the national average, a considerable change from having been 3% above average in 1992. In 2006, Arizona ranked 45th among all states, down from 18th in 1992.

A more comprehensive look at the history of own-source revenue in Arizona relative to the national average is shown in Figure 9.1. Per capita and relative to personal income, Arizona revenue as a ratio to the national average was much higher during the 1960s than in subsequent years. From the 1970s into the early 1990s, state and local government revenue in Arizona per \$1,000 of personal income fluctuated near the national average; the per capita figure usually was 5-to-10% less than the U.S. average. Since the mid-1990s, both measures have been considerably below the historical norm. Arizona's rank among the states also has declined.

Taxes

Own-source tax revenue was \$19.9 billion in Arizona in 2006, accounting for 55% of all revenue. On a per capita basis, this amounted to \$3,291—18% less than the U.S. average, ranking 37th in the nation. (In 2005, the per capita figure was 16% below average, with a rank of 35th.) Per \$1,000 of personal income, Arizona was 8% below the national average and ranked 40th. (In 2005, Arizona was 4% below average and ranked 30th.) These recent

Figure 9.1
Own-Source General Revenue in Arizona as a Percentage
of the National Average, Combined State and Local Government,
Fiscal Years 1964 Through 2006



Note: Data for 2001 and 2003 are estimated.

Sources: U.S. Department of Commerce, Census Bureau (revenue and population) and Bureau of Economic Analysis (personal income).

figures represent a considerable change from 1992, when the per capita figure was only 8% below average and ranked 27th; per \$1,000 of personal income, Arizona ranked 10th in 1992 at 7% above average.

Sales and Gross Receipts Tax

The sales and gross receipts category includes the general sales tax (transaction privilege tax in Arizona) and selective sales taxes. Other than federal funds, the general sales tax was the largest single source of revenue in Arizona, with collections of \$7.5 billion in 2006 accounting for more than 20% of total revenue. The state's use of this tax was far above the norm. Per capita, collections were 30% above average, 10th in the nation. Relative to personal income, collections were 47% above average, eighth in the nation. These ranks were about the same as in 1992.

Arizona collected \$1.9 billion from selective sales taxes. Per capita, this was 29 below average, ranking 43rd. Relative to personal income, it was 20% below average, further below average than in the early 1990s. Arizona ranked 40th among all states in 2006.

The various selective sales taxes are shown in Table 9.1. On both measures, Arizona was far below the norm on collections from alcoholic beverages, public utilities, and miscellaneous other selective sales taxes. Per \$1,000 of personal income, the ratio to the national average has fallen significantly since the early 1990s in the public utilities and alcoholic beverages categories. In contrast, due to the voter-approved initiative raising tobacco taxes in 2002, Arizona went from below to above the national average on tobacco tax collections per \$1,000 of personal income.

Property Tax

Though the state portion of the property tax was eliminated in 1997, the property tax remains a major source of revenue to local governments. A total of \$5.5 billion was collected in 2006, some 15% of all state and local government revenue. On a per capita basis, Arizona's collections were 24% less than the national average, ranking 36th overall. Relative to personal income, collections were 15% below average; they had been 11% above average in 1992. Arizona's rank fell from 19th to 33rd overall. Since 2006, reductions in assessment ratios for business property taxes have been phased in.

Income Tax

The individual income tax provided revenue of \$3.3 billion in 2006, or \$537 per resident. This was 41% below the national per capita average, ranking 40th overall. Relative to personal income, Arizona's collections were 33% less than average in 2006, down from 15% below average in 1993 (the first year the Census Bureau separated the individual and corporate income taxes). Arizona ranked 40th in 2006 (36th in 1993) overall. With nine states not applying the income tax to wages, collections in Arizona were among the lowest of those states levying the tax. Since 2006, significant additional decreases in personal income taxes have been implemented.

The corporate income tax raised \$890 million in 2006. Collections from this source are erratic from year to year, with the 2006 figure unusually high due to the strong economy at that time.

On a per capita basis, Arizona's collections were 17% below average, but ranked 17th overall. Relative to personal income, collections were 7% below average (ranked 24th); over time Arizona has ranged from above to considerably below the U.S. average. Further reductions in corporate income taxes have been implemented since 2006.

Other Taxes

The Census Bureau considers the portion of the motor vehicle license tax based on the value of the vehicle to be a property tax—a different categorization than used by the state of Arizona. Thus, the Census Bureau's vehicle license tax category is limited to various fees. Using this definition, less than \$200 million was collected from this source in 2006. The per capita figure was less than half the national average. Per \$1,000 of personal income, the 2006 collection was 48% less than the national average and ranked 49th.

Collections from miscellaneous other taxes amounted to \$733 million in 2006. Arizona's collections were far less than the national average: 56% below average per capita (ranked 45th) and 50% below average relative to personal income (ranked 43rd). The ratio to the national average changed little over time.

Nontax Sources

Nontax sources of revenue brought in \$7.7 billion to state and local governments in Arizona in 2006, accounting for 21% of the total. Nationally, the share was nearly 25%. Per capita, the state ranked last in nontax revenue in 2006 at 30% below the national average. Per \$1,000 of personal income, Arizona's collections in 2006 were 20% below average, 47th in the nation. In 1992, Arizona was not as far below the personal income norm, just 5% below average and ranked 37th. In most years prior to 1992, Arizona's figure had been above the national average relative to personal income, by substantial amounts in some years.

User fees accounted for more than half of the nontax revenue in Arizona in 2006. Per capita collections were 35% below the national average, fourth lowest in the nation, and collections per \$1,000 of personal income were 27% below average, 43rd in the nation. Arizona fell somewhat further behind the national norm over time.

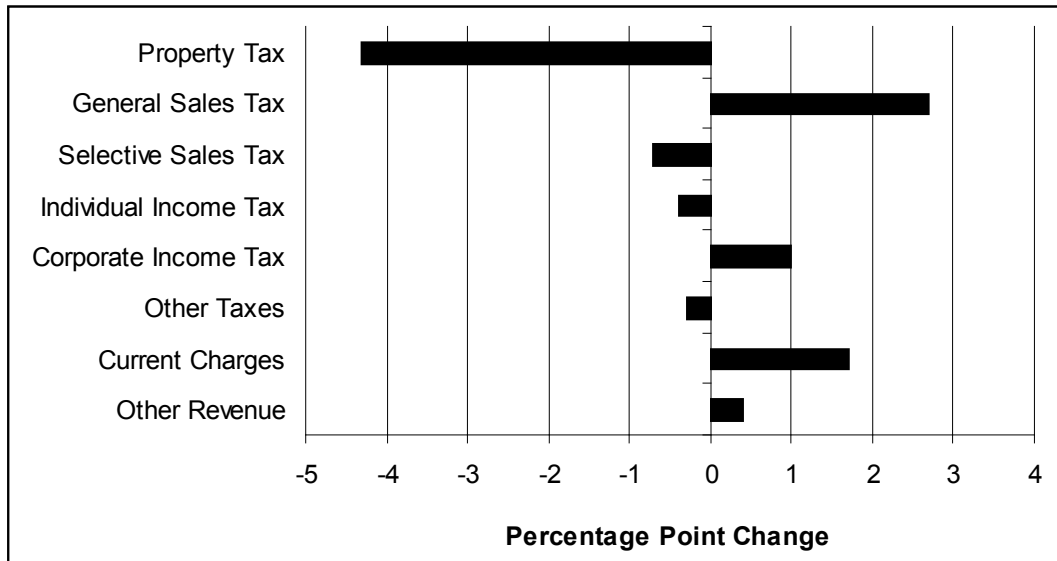
Of the many types of user fees shown in Table 9.1, Arizona collected less than average on most. The decline in use fees per \$1,000 of personal income as a percentage of the U.S. average, from 85% in 1992 to 73% in 2006, mostly was due to a decrease in the higher education subcategory.

Arizona also was considerably below average on miscellaneous other sources of revenue in 2006. It was below average in interest earned, and much below average in the miscellaneous "other" sources of revenue.

Change in Revenue Mix Over Time

The mix of revenue sources used by state and local governments in Arizona has shifted over time. Since 1993, the share of total general revenue coming from the property tax has dropped. This has been replaced by a growing dependence on the general sales tax. User fees (current charges) also have made up an increasing share of total own-source revenue (see Figure 9.2).

Figure 9.2
Revenue by Source as a Percentage of Total Own-Source Revenue,
Combined State and Local Government, Arizona,
Change Between Fiscal Years 1993 and 2006



Source: U.S. Department of Commerce, Census Bureau, *State and Local Government Finances*.

However, some of these changes may be reflecting the economic cycle: 2006 was the peak of its cycle while 1993 was a recovery year from the 1991 recession.

TAX BURDEN

Using Census Bureau data, the tax burden in Arizona in 2006 ranked 37th among the 51 states on the per capita measure and 40th nationally on the personal income measure. These ranks were considerably lower than those prior to the mid-1990s.

Two alternative measures of tax burden use considerably different methods and data than the Census Bureau, yet are consistent in showing that Arizona's tax burden is considerably below the national norm and has fallen substantially over time. The Tax Foundation ranked Arizona 41st among the 50 states in 2008. The government of the District of Columbia ranked Arizona in 2007 at between 41st and 44th among the 51 states at four income levels, but 17th at the lowest income level.

Tax Foundation Measure

The Tax Foundation measure of tax burden is designed to answer the question "How much are the residents of a state paying to state and local governments, regardless of the state in which the government is located?"² In order to answer this question, tax burdens are shifted as necessary from the state of collection to the state of residence of the taxpayer. For example, residents of Alaska do not pay the high severance taxes levied in that state on the extraction of oil and other natural resources. Instead, these taxes are treated like other business expenses by the mining companies and are incorporated into the price of the natural

resource sold by these companies. Thus, consumers around the country ultimately pay those taxes as part of the retail price.

In addition to this geographic shifting of the tax burden, the Tax Foundation measure is different from other measures in the way in which both taxes and income are defined. Instead of using the Census Bureau data for taxes, the release of which lags behind by a couple of years, the overall state and local tax estimate of the U.S. Department of Commerce, Bureau of Economic Analysis (BEA) is used. The BEA estimate is conceptually equivalent to the Census Bureau's definition of a tax plus special assessments.

Like the per capita and personal income measures, the Tax Foundation's measure of tax burden should not be defined as the ability of a state's residents to pay taxes. While it adjusts for taxes paid by nonresidents, the estimate of taxes includes taxes paid by businesses as well as personal taxes. The income measure is similarly broad, including all sources of money income to all businesses and individuals.

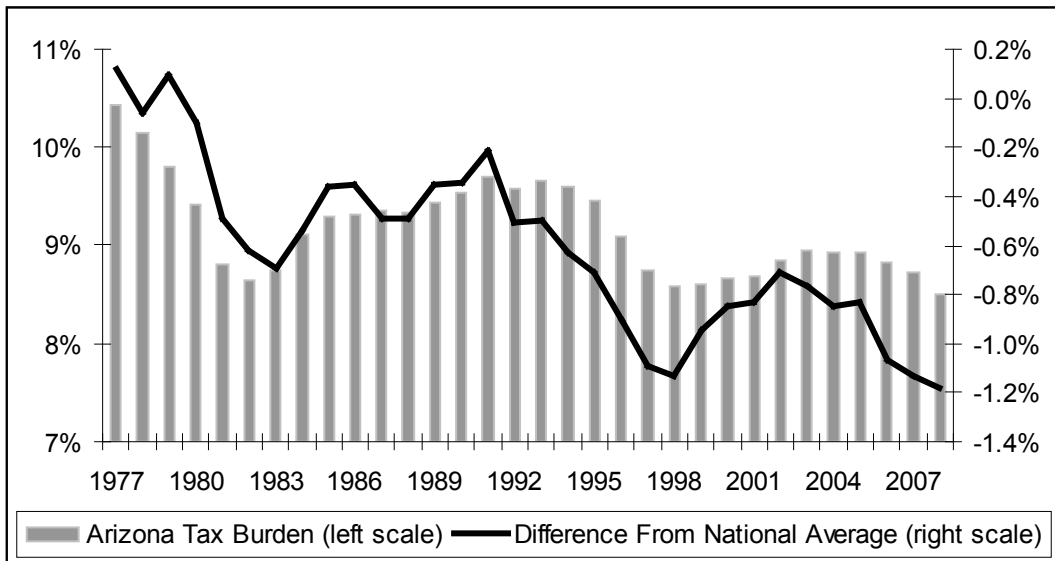
As calculated by the Tax Foundation, the state and local government tax burden—defined as per capita taxes as a share of per capita income—from 1977 (the first year available) through 1980 was about equal in Arizona to the national average at around 10% of income, though Arizona ranked above the median state (between 17th and 21st). State government tax reductions from 1979 through 1981 sent Arizona's burden down, to below the national average. Since 1981, Arizona's tax burden has always been lower than the U.S. average. An inability to balance the budget led to a subsequent tax increase in 1983, but the burden during the rest of the 1980s remained less than in the late 1970s.

When the Arizona economy slowed in the late 1980s, state government revenue was insufficient to meet the needs, causing spending reductions and further tax increases. The tax burden approached the national average in 1991 when Arizona ranked 25th among the states. However, even after the increases, the tax burden remained below the pre-1980 level as well as below the national average (see Figure 9.3).

A series of state government tax cuts began in the early 1990s, lowering the tax burden to below the level of the early 1980s. Since 1991, Arizona's tax burden has declined from 9.7% of per capita income to 8.5% in 2008. The national average tax burden barely dropped during this period and was 9.7% in 2008. The burden in Arizona in 2008 was 1.2 percentage points less than the national average, the largest differential on record. Arizona ranked 41st among the 50 states, its lowest rank on record, down from a rank of 17th in 1977.

Thus, the Tax Foundation results are consistent with the Census Bureau data in showing that the tax burden in Arizona is among the lowest in the country and has fallen significantly over time, particularly since the early 1990s. While the Census Bureau's government finance data are used by the Tax Foundation, the Tax Foundation's geographic allocation of taxes is very different from that of the Census Bureau. Further, the Tax Foundation reports tax data two years more current than the Census Bureau, relying on the BEA data to drive these more up-to-date estimates. In addition, the Tax Foundation's measure of income is different from the personal income measure used to adjust the Census Bureau data.

Figure 9.3
Combined State and Local Government Tax Burden in Arizona,
1977 Through 2008



Source: Tax Foundation.

District of Columbia Measure

Another approach to comparing tax burdens across geographic areas is to select a hypothetical household based on household composition, income, and other factors. The tax burden for this household is calculated using the actual tax code in every state. These studies typically limit the analysis to major taxes paid directly by households and often select just one hypothetical household, typically of upper-middle income, since this method is very labor intensive. Because the property tax varies by place within a state, these studies usually pick one city in each state to compare. Since these studies actually work through the tax code of each state, they potentially result in an accurate portrayal of geographic variations in tax burden for the selected household, but should not be generalized to other households. A similar approach can be used to compare business taxes.

A study conducted annually by the government of the District of Columbia is an example of the hypothetical household approach to comparing tax burden.³ It calculates the tax bill for a family of three at five widely different income levels ranging from \$25,000 to \$150,000.

The District of Columbia study uses the tax code of each state in each year for four tax categories: individual income tax, residential property tax, general sales and use tax, and automobile taxes (including gasoline tax, registration fees, excise tax, and personal property tax). Taxes are calculated for the largest city in each state and for the District of Columbia.

The results of the 2007 District of Columbia study are summarized in Table 9.2. The overall tax burden in Phoenix was substantially below the norm, ranking between 41st and 44th, except in the lowest income category. The income tax and property tax burdens were quite low, the sales

tax burden was very high, and the automobile taxes were close to the norm except among the higher incomes.

Thus, the results of the District of Columbia study are consistent with the other measures, indicating that the individual tax burden in Arizona (as measured in Phoenix) is among the lowest in the country.

Table 9.2
Household Tax Burden,
Combined State and Local Government, Phoenix, Arizona, 2007

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

* Tax assumed to be equal in all states.

t: tie.

Source: Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison*.

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¹ U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

² Tax Foundation, <http://www.taxfoundation.org/news/show/335.html>.

³ Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison, 2007* (August 2008), <http://cfo.dc.gov/cfo/cwp/view,a,1324,q,612643.asp>.

Chapter 10

THE EFFECTS OF THE ECONOMIC CYCLE ON GOVERNMENT REVENUE

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KEY POINTS

- Arizona's economy is one of the most volatile in the nation. Arizona grows much faster than the nation during expansions, but suffers equally with the nation during recessions.
- General fund revenues are far more volatile than the economy itself. Inflation-adjusted revenues can grow by more than 20% during strong expansions and decline by a similar amount during recessions.
- Arizona's general fund revenue structure is extremely cyclical. The three major revenue sources—sales and use taxes, individual income tax, and corporate income tax—each decline much more than the general economy during economic downturns and rise considerably more during economic expansions.
- Income tax collections, especially from the corporate tax, are particularly volatile, but collections from the sales and use tax also have been quite cyclical in recent years.
- While government revenues rise and fall during the economic cycle, demand for government services as a whole grows at a relatively steady pace throughout the business cycle.
- The demand for some government services is countercyclical, rising more during recessions when people lose their jobs and qualify for government-provided healthcare benefits and various welfare programs. Government safety net programs were established for that very purpose—to aid individuals and families in times of need.
- The key to responsible management of the state's finances is an adequately funded budget stabilization fund.

THE ECONOMIC CYCLE IN ARIZONA RELATIVE TO THE NATION

Economic growth around the globe and over time has been cyclical. The typical cycle consists of a period of rapid economic growth and a shorter period during which the size of the economy contracts (after adjustment for inflation). In the United States, the typical economic cycle through the 1950s had a length of only about four years. Since then, some cycles have been longer, up to 10 years in length.

The economy of each state is cyclical, though not all state economic cycles coincide with the national cycle.¹ The timing of Arizona's economic cycle usually is quite similar to the national average, but the difference in growth rates from the cyclical peak to trough are unusually large. In fact, Arizona has long had one of the most volatile state economies in the country.

An index based on quarterly personal income shows that Arizona is second only to Nevada for economic volatility over the period stretching from 1950 through the first quarter of 2009. All of the states with the most volatile economies are in the South or West (see Table 10.1). The common link between these states is their rapid population growth. Nationwide, the construction and real estate sectors experience substantial cyclical. In fast-growing states in which these sectors account for an above-average share of economic activity, the overall economy tends to be relatively more cyclical.

Figure 10.1 compares annual rates of growth in quarterly inflation-adjusted personal income for Arizona and the nation. This graph clearly shows that the reason why Arizona's economy is so volatile relative to the national average is that it grows very rapidly during business expansions, while it suffers equally during recessions. During expansions, Arizona's much more rapid economic growth results mostly from its much greater population growth rate. During recessions, despite still experiencing more rapid population growth, the state's personal income growth falls at about the same rate as the national average. During the last five recessions, the decline in personal income in Arizona was worse than the U.S. average in three and about the same in one. In the other recession, personal income never decreased in Arizona.

For example, during the early 1970s, Arizona's annual growth rate in real personal income peaked at 12.1%, compared to the national average of 7.2%. During the ensuing recession, national personal income fell as much as 1.8% on an annual basis while the annual rate of decline in Arizona exceeded 3%. More recently, personal income during the year ending in third quarter 2005 expanded 8.2% in Arizona compared to only 1.9% nationally, though the national rate reached 4.2% in 2006. During the four quarters through first quarter of 2009, the most recent data available, the economy contracted 1.3% nationwide, while the decrease in Arizona was larger at 2.7%.

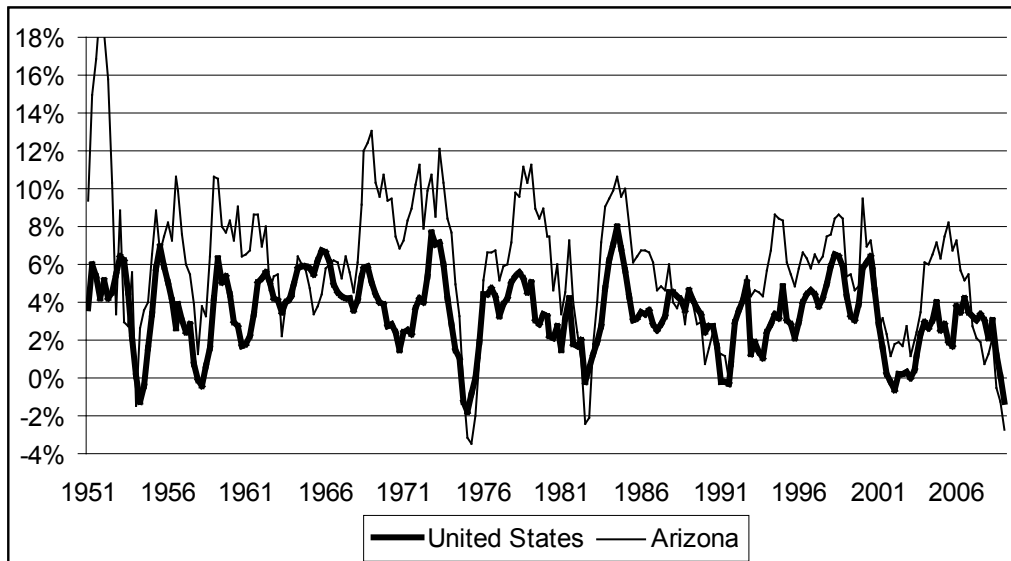
Table 10.1
Volatility Index, 10 Most Volatile State Economies

		Index*
1	Nevada	130.6
2	Arizona	119.5
3	Florida	113.7
4	Colorado	112.2
5	Utah	111.1
6	Georgia	110.8
7	Texas	110.5
8	Washington	107.8
9	Idaho	107.6
10	North Carolina	107.5

* U.S. average = 100.

Source: Economic and Business Research Center, Eller College of Management, the University of Arizona.

Figure 10.1
Annual Real Percentage Change in Personal Income Based on Quarterly Data,
Arizona and United States, 1951 Through 2008



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

CYCLICALITY OF GOVERNMENT REVENUE IN ARIZONA

The state of Arizona's general fund ongoing revenue stream is much more volatile than the economy itself. Figure 10.2 displays inflation-adjusted annual growth rates based on quarterly data from 1988 through early 2009. General fund revenue collections have fluctuated far more wildly than personal income. In addition to containing more quarter-to-quarter variability, rates of growth in revenue collections are much higher during business expansions and much lower in recessions than growth rates in personal income. For example, during the third quarter of 2005 when the economy was soaring, revenues surged 24.2% compared to the prior year, while growth in personal income registered 8.2%. Between the first quarters of 2008 and 2009, revenues fell 26.0% while personal income declined 2.7%.

The overall revenue line in Figure 10.2 reflects tax code changes in addition to cyclical swings in collections. However, the Arizona Joint Legislative Budget Committee has since 1989 made estimates of the effects of tax code changes. Using these estimates to adjust actual annual revenue collections, it is possible to estimate what revenues would have looked like without the tax changes, as shown in Figure 10.3. The lines in this chart are adjusted for both inflation and population growth. In each recessionary period, real per capita revenue decreased considerably more than did real per capita personal income. In other years, revenue growth has ranged from similar to, to much higher than, economic growth.

In each of the last five recessions, annual average real per capita personal income has dropped in one or two fiscal years; another year of slow or no growth has resulted in a total of two-to-three years of subpar economic performance. In contrast, the period of weakness in real per capita government revenue growth in each down cycle has lasted at least a year longer.

Figure 10.2
Annual Real Percentage Change in Arizona State Government General Fund Revenue and Arizona Personal Income, Based on Quarterly Data From 1988 Through Early 2009

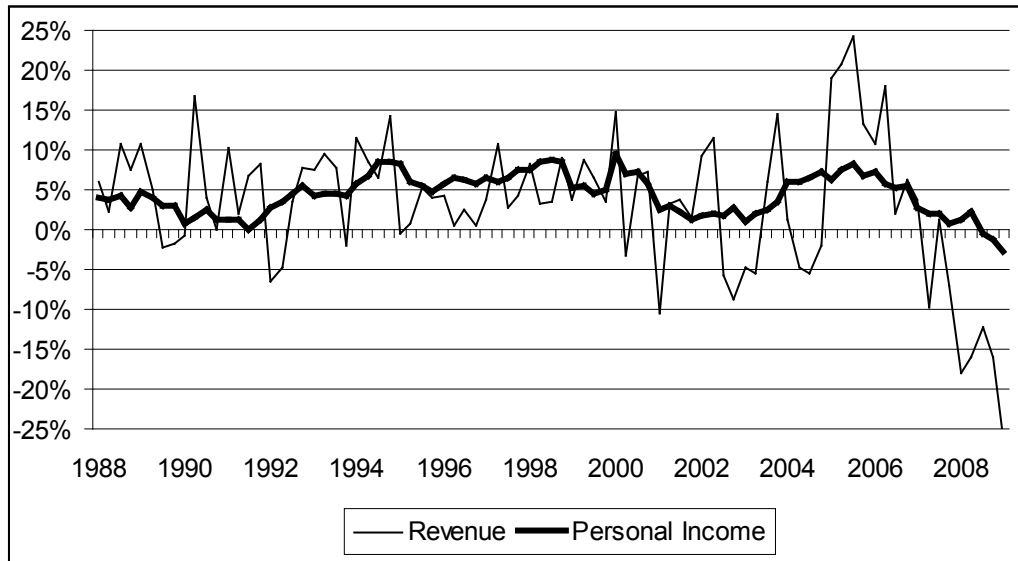
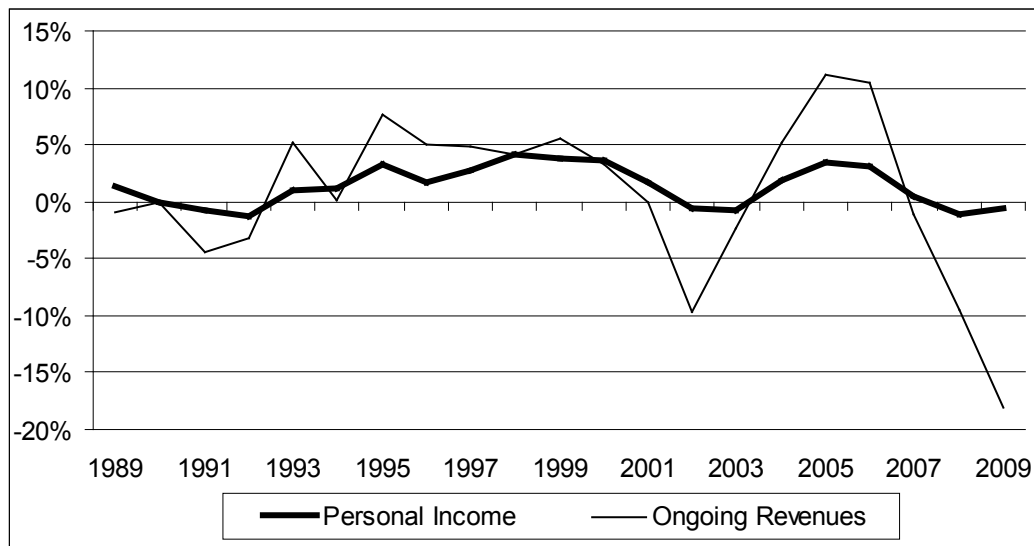


Figure 10.3
Estimated Annual Real Per Capita Percentage Change in Arizona State Government Ongoing General Fund Revenue and Arizona Personal Income, Fiscal Years 1989 Through 2009



Source (Figures 10.2 and 10.3): Arizona Joint Legislative Budget Committee (revenues) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income, population, and GDP implicit price deflator). Figure 10.2 presents actual data and does not adjust for population growth while Figure 10.3 adjusts actual revenues for changes in the tax code and includes an adjustment for population growth.

Growth in real per capita personal income and real per capita revenue (after adjusting for tax law changes) peaked in fiscal years 2005 and 2006, with the revenue gains unusually strong at more than 10% in each year. Growth slowed sharply in fiscal year 2007, with the revenue measure decreasing slightly. In fiscal year 2008, the revenue measure fell nearly 10%, compared to a 1% drop in the economic measure. The revenue measure fell again in fiscal year 2009, by an unprecedented 18%, while the economic measure dropped only slightly.

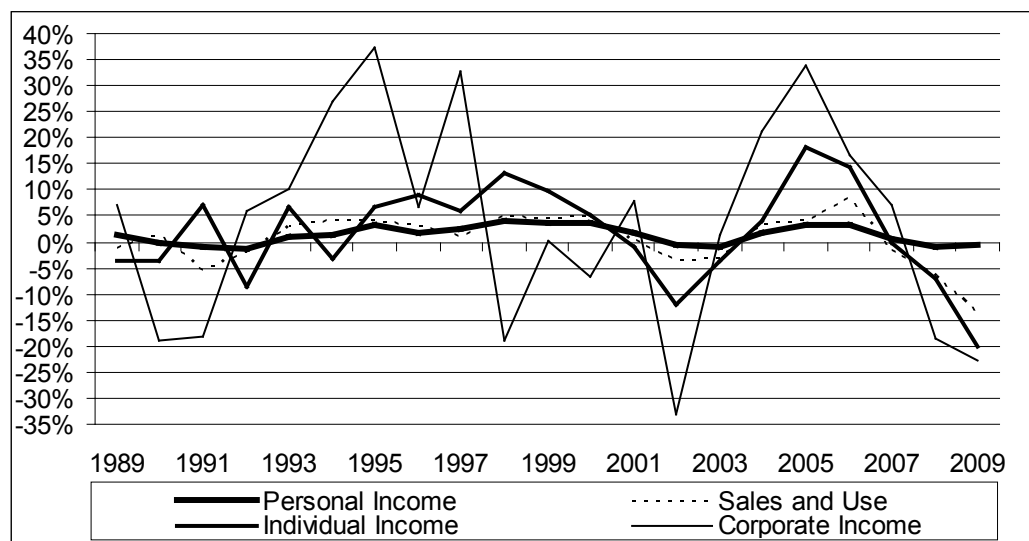
Using the JLBC estimates of the effects of tax code changes to individual revenue sources, the fluctuations in the income and sales and use taxes are presented in Figure 10.4. (Since the state portion of the property tax was eliminated, it was not possible to estimate this tax source.) The lines in this chart are adjusted for both inflation and population growth.

Income Tax

Income tax revenues are considerably more volatile than sales and use taxes, as shown in Figure 10.4. Collections from the corporate income tax have been more volatile than from the individual income tax, but the volatility of the latter has increased since the mid-1990s. During this period, percentage changes in adjusted real per capita individual income tax revenues varied from 13% in 1998 to -12% in 2002 to 18% in 2005 to -20% in 2009. The range in growth rates in real per capita personal income was only from 4.1% to -1.1%.

Another way of looking at the individual income tax is to examine taxable income.² This series, representing the tax base, is computed before any tax rates (or tax cuts) are applied.

Figure 10.4
Estimated Annual Real Per Capita Percentage Change in Major Sources of Arizona State Government General Fund Revenue and Arizona Personal Income, Fiscal Years 1989 Through 2009



Source: Arizona Joint Legislative Budget Committee (revenues adjusted for changes in the tax code) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income, population, and GDP implicit price deflator).

Though the annual pattern is somewhat different in Figure 10.5 than in Figure 10.4, the conclusion is the same in terms of the high volatility of the individual income tax relative to economic performance. (Figure 10.5 adjusts for inflation but not for population growth.)

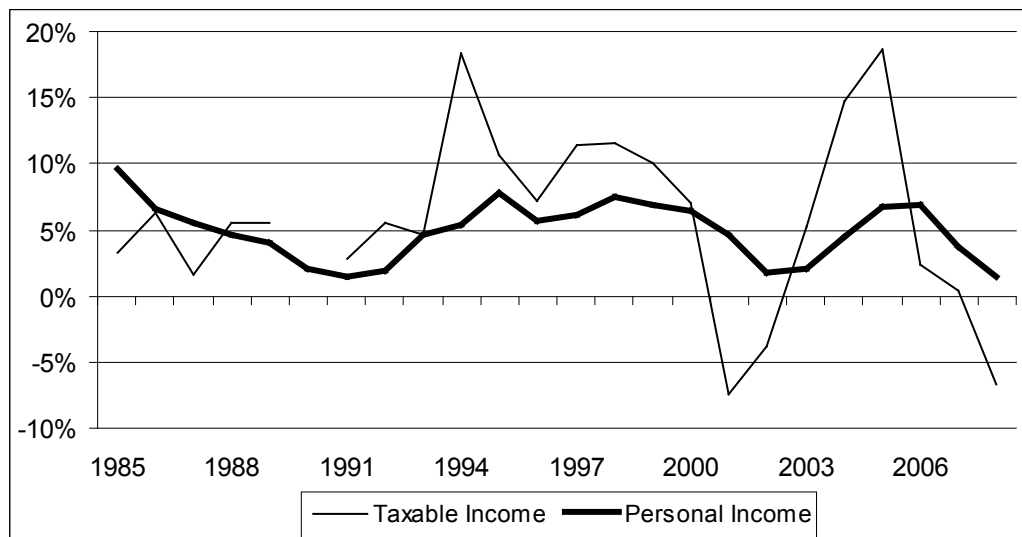
Much of the volatility in taxable income during this period is due to realized capital gains. According to the Federation of Tax Administrators and reported by the National Association of State Budget Officers,³ realized capital gains increased by more than 300% between 1994 and 2000 and state treasuries reaped windfall gains. Unfortunately, these one-time realized capital gains were interpreted as a trend line and permanent tax cuts were made. After plummeting around the 2001 recession, capital gains again soared (see Figure 10.6). Taxes again were permanently cut. The tax reductions during the 1990s and again more recently are contributing to the current fiscal condition of Arizona. Capital gains almost certainly have again plunged since 2007, the latest data available.

Corporate income tax revenues are the most volatile of the three major revenue sources to the general fund. Annual changes in corporate income tax revenue frequently have exceeded 20% in both directions, even after adjustment for inflation and population growth.

Sales and Use Tax

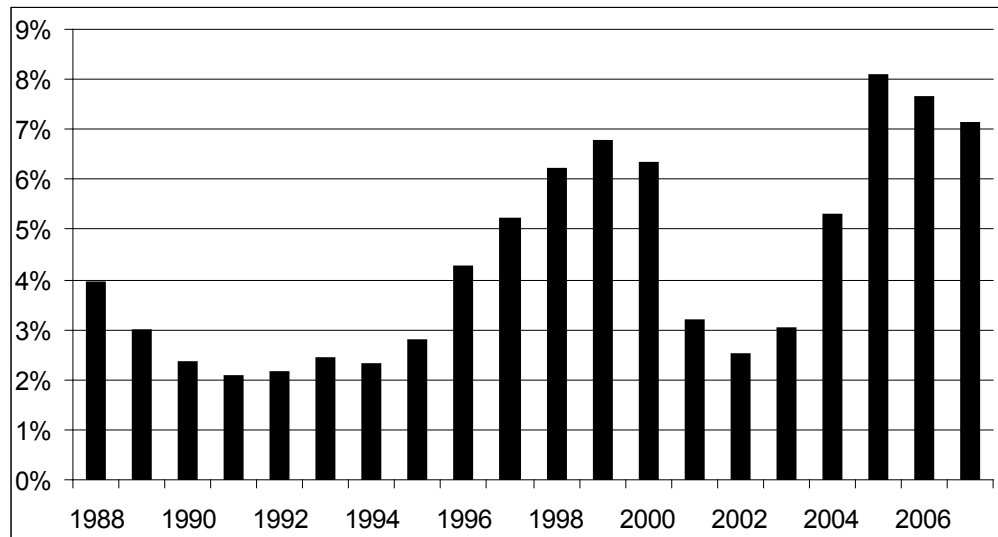
Until recent years, sales and use tax collections were more cyclical than personal income but much less volatile than the income taxes. After an unusually high peak in 2006, sales and use tax collections have fallen sharply, though still not as much as income tax collections.

Figure 10.5
Annual Real Percentage Changes in Taxable Income and Personal Income, Arizona, 1985 Through 2008



Source: Arizona Department of Revenue (taxable income) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income and GDP implicit price deflator). Taxable income is estimated for 2008 and not shown for 1990 due to changes to the tax structure.

Figure 10.6
Capital Gains as a Percentage of Personal Income,
Arizona, 1988 Through 2007



Sources: Internal Revenue Service (capital gains) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

Relative to personal income, sales tax collections fell during the 1990-91 recession, then rebounded in 1993-94. Otherwise, the growth rates were similar during the 1990s expansion. As in the prior economic cycle, sales tax collections fell (from 2001-03), then rebounded (2006). The current recession officially began in December 2007, but Arizona's economy was already slowing substantially by July 2007. The real per capita sales and use tax growth rate fell from more than 8% in 2006 to -1.8% in 2007, -6.6% in 2008, and -13.5% in 2009. Arizona's real per capita personal income growth fell much less, from 3.4% in 2005 to -1.1% in 2008. Among the largest components of Arizona's sales tax base, retailing and utilities are the least volatile, while contracting sales and use tax sales are the most volatile.

NONCYCLICALITY OF GOVERNMENT SPENDING NEEDS

While government revenues rise and fall during the economic cycle, demand for government services as a whole grows at a relatively steady pace throughout the business cycle. Demand for most services rises fastest during expansions when population growth is the most rapid. Demand for most of these services—for example, elementary and secondary education—continues to rise during recessions, though at a lesser pace. In contrast, the demand for some government services is countercyclical, rising more during recessions when people lose their jobs and qualify for government-provided healthcare benefits and various welfare programs. Government safety net programs were established for that very purpose—to aid individuals and families in times of need. During long and deep recessions, even enrollment at institutions of higher education goes up at an unusual rate, as those who otherwise would be employed choose to enhance their educations while unemployed or underemployed.

Actual spending is one measure of the demand for services, but since state and local governments must produce a balanced budget each year, spending is constrained by available revenues. Expenditures often are reduced during recessions. For this reason, as well as the addition and deletion of government programs for other reasons, a time series of government spending does not adequately illustrate the cyclical pattern of public demand.

Caseloads also provide an indication of the demand for public services, but changes in eligibility requirements can affect these figures as well. Typically, caseloads begin to rise a little before the official beginning of a recession, then rise rapidly through the recession. In the current recession, for example, 16% more people were enrolled in the Arizona Health Care Cost Containment System on August 1, 2009 compared to August 1, 2008. The number of recipients of nutrition assistance (previously called food stamps) surged 36% from July 2008 to July 2009.

During the last two economic cycles, caseloads continued to rise at a rapid pace for about two years after the official end of the recession. In each case, the two years were marked by slow economic growth in which unemployment continued to rise. The total increase in caseloads from the trough shortly before the recession to the peak two years after the end of the recession may exceed 100%. Once caseloads peak, they fall steadily throughout the expansionary period. The total decline may be on the order of 50%.

This mismatch between available revenue and spending needs during recessionary periods is at the core of public finance issues. Diversification will do little to reduce the cyclicity of the Arizona economy. Moreover, modifying the revenue system to eliminate the most volatile components (as described in Chapter 16) will reduce the severe cyclicity in government revenue flows, but at the expense of other guiding principles (see Chapter 11), such as fairness and equity. The key to responsible management of the state's finances is an adequately funded budget stabilization fund (see Chapter 17).

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¹ For a recent review of the business cycle in states and a bibliography see Michael T. Owyang, Jeremy Piger, and Howard J. Wall, "Business Cycle Phases in U.S. States," *The Review of Economics and Statistics* 87, No. 4 (November 2005): 604-616.

² Arizona Department of Revenue. Figures for 2008 are estimated.

³ National Association of State Budget Officers, *Budgeting Amid Fiscal Uncertainty: Ensuring Budget Stability by Focusing on the Long Term* (2004), <http://www.nasbo.org/Publications/PDFs/budgetstabilityFeb2004.pdf>.

Chapter 11

REVENUE SYSTEM GUIDING PRINCIPLES¹

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KEY POINTS

- The guiding principles of an ideal revenue system are well established. However, the ideal system varies somewhat by state due to differences in economic structure, resources, demographics, and citizen attitudes.
- The amount of revenue to be collected does not affect the design of the ideal system.
- In order to realize a best-practices revenue system, the system must be considered as a whole, not as a set of unrelated components.
- In addition to adhering to the guiding principles, a well-functioning fiscal system includes a strong budget stabilization fund.
- Arizona's revenue system compares poorly against the characteristics of a well-functioning system, contributing to cyclical and structural budget deficits.
- Arizona's revenue system falls short on nearly all of the guiding principles, including stability, predictability, responsiveness, efficiency, competitiveness, neutrality, horizontal equity, vertical equity, and simplicity.
- Considerable improvement to Arizona's revenue system is possible. Altering the current mix of revenue sources and the budget stabilization fund are keys to achieving a system that is more in line with an ideal system.
- A *fiscal* system consists not only of the revenue system, but also expenditures and debt. Additional guiding principles beyond those specific to the revenue system apply to the fiscal system. A key fiscal principle is to link revenues and expenditures.

BACKGROUND: DESIRABLE REVENUE SYSTEM POLICIES

Since the revenue issues Arizona faces are common to most states, these issues have been thoroughly discussed by groups such as the National Conference of State Legislatures (NCSL) and the National Governors Association (NGA). Considerable agreement has existed for a couple of decades on solutions to the issues.

Financing State Government in the 1990s²

Even at the time of this 1993 joint publication of the NCSL and NGA, state tax policy was outdated in most states, largely having been put into place decades earlier (primarily during the 1930s) and haphazardly adapted since then. Little has changed since 1993. The result is an inefficient and unreliable revenue system used by many state governments.

The means by which wealth is generated and the ways in which income is expended have changed substantially since the 1930s. In particular, manufacturing and consumption of goods have proportionally decreased, replaced in importance by services. Interstate and international trade has advanced. The share of purchases from catalogs and the Internet have increased. The changing age distribution of the population affects the composition of income

and the amount and composition of consumption. With these economic and demographic changes predicted to continue, the negative revenue impacts on outdated fiscal systems will continue to worsen. The sales tax, personal income tax, and business taxes have been especially impacted by the tax code not keeping pace with economic change.

General recommendations in *Financing State Government in the 1990s* included (1) review fundamental and structural issues in the ways that changing economic conditions are affecting tax structure, (2) consider tax policy as a system, not as a set of unrelated components, (3) evaluate the impact of economic development incentives on tax policy, and (4) cooperate with other states. Among the specific recommendations of the NCSL and NGA was to

- Expand the sales tax base. While taxing many services is desirable, business services should be excluded since the sales tax is a tax on consumers and should not be applied to components of production.
- Reconsider removing the sales tax on food. Exempting groceries is “an expensive way to benefit the poor since affluent people receive a greater gain.”
- Expand the use of personal income taxes.
- Review exemptions, deductions, and exclusions from the income tax.
- Reconsider tax breaks for the elderly without adjustment for income levels.

Principles of a High-Quality State Revenue System³

Work on the first edition of this NCSL publication began in the 1980s. The fourth edition was released in 2001 and updated in 2007. The latest edition identifies additional concerns that emerged during the 1990s:

- The evolution of fiscal federalism. Despite fluctuating federal intergovernmental aid, Congress has delegated increased responsibilities to state and local governments, with state governments in turn placing additional mandates on local governments.
- Pressures on state revenue systems. Rapidly escalating costs for some programs—especially Medicaid (Arizona Health Care Cost Containment System [AHCCCS] in Arizona), other health care, and corrections—have strained the ability of revenue systems to produce sufficient funds.
- The changing nature of state revenue systems. Tax bases have become narrower and less responsive to economic growth as consumption patterns have shifted from goods to services, as tax limitation movements have restricted property taxation, and as large portions of total personal income have been exempted from the income tax.
- Intensified interstate and international economic competition. States have re-examined the competitiveness of existing tax structures and have modified tax policies to enhance economic development.

The NCSL report emphasizes the “system” in “revenue system”—interrelationships exist among the revenue sources such that the whole set of sources should be considered as a group. A revenue system can more easily meet such goals as equity and minimal economic impact than can individual revenue measures.

A single model for a high-quality revenue system can be developed. However, state-to-state differences in economic structure, resources, demographics, and citizen attitudes mean that

the ideal model will look somewhat different in each state. The NCSL report identifies nine principles that should be considered in all systems:

1. **Complementary.** Elements of the system should not be contradictory, particularly the relationship of state and local governments.
2. **Reliability.** Revenues should be stable, certain (the number and types of tax changes should be kept to a minimum), and sufficient (to balance the budget in the short term and to grow in the longer term). Tying a particular expenditure program to a specific revenue source (“earmarking”) lowers reliability and generally should be avoided for general expenditures.
3. **Balance.** Diverse and balanced revenue sources should be used. Reliance on income, sales, and property taxes should be in roughly equal proportions, with a number of other taxes supplementing the three major sources.
4. **Equity.** Similar tax burdens should be imposed on people in similar circumstances (horizontal equity); regressivity should be minimized (vertical equity); and taxes on low-income individuals should be minimized, based on the concept of ability to pay. Equity of the system is more important than that of an individual revenue source.
5. **Compliance.** Taxpayers should be able to easily understand the system and compliance costs should be minimized. Complexity is a particular issue for businesses, especially those operating in multiple jurisdictions.
6. **Administration.** The system should be as simple as possible to administer, applied uniformly, and raise revenue efficiently.
7. **Responsive.** The system should respond to interstate and international economic competition. Tax levels relative to other states should be considered. Benefits should be compared to costs when revenue systems are used as tools of economic development.
8. **Involvement.** The impact on spending decisions should be minimized. The costs of tax deductions, exemptions, and credits should be made explicit and thoroughly evaluated on a regular basis, as should the earmarking of funds for specific purposes.
9. **Accountable.** The system should be accountable to taxpayers.

The NCSL report also discusses the distribution of taxes between businesses and individuals. Resolving this issue is complex; taxing businesses presents many difficulties. The main justification for taxing businesses is that they receive public services, such as police protection and highways—taxes are the price paid for these services. This suggests that businesses should pay taxes regardless of their profits, which in turn suggests that a corporation income tax should not be the only or major means of collecting taxes from businesses. Another reason for taxing businesses is administrative efficiency. Businesses are intermediaries in economic processes from which it is administratively convenient to collect taxes. Chapter 13 discusses business taxes in more detail.

Governing

Governing magazine periodically publishes results of its ongoing Government Performance Project. An in-depth analysis of state tax systems was published in the February 2003 issue.⁴ This study found that the tax system in most states was inadequate to meet the needs of the 21st century, that most systems were unfair by not assessing the lowest possible rates on the widest possible base of taxpayers, and that budgets for tax collection agencies were being

reduced. *Governing* notes that regardless of the amount of revenue that is desired, balanced revenue sources are critical to any system.

The current difficulties faced by almost all state governments and the similar revenue shortfalls experienced during the prior recession were predicted years ago by those who understand the cyclicity of economic growth and revenue flows. The states (including Arizona) broke two fundamental rules of finance: do not pay for ongoing expenses with one-time revenues and do not reduce prices (tax rates) in response to a transitory surge in revenues.

The importance of the three major tax sources—general sales, personal income, and property—is highlighted in the report, with corporate taxes also considered an important fourth source. Relatively balanced reliance among the major sources is considered the best policy given differences in cyclicity across the revenue sources. Generally, income tax collections are considered to be the most cyclical of the major tax sources, followed by sales tax collections; property tax collections usually exhibit less cyclicity.

The sales tax has become increasingly used by state and local governments, yet its tax base has not kept pace with economic change. The magazine states that relying on the sales tax as currently structured is increasingly limiting, due to the shift in consumption from taxed goods to untaxed goods and services. The rising use of sales tax exemptions also limits collections.

Corporations still contribute significantly to state and local government revenues through the sales and property taxes, but *Governing* reports that the share of revenues from the corporate income tax is falling. One reason for this is that states are changing the formulas that determine the corporate income tax due, with many shifting to tax formulas based heavily on the portion of sales that take place in the state. Corporate tax collections also are falling due to increased use of incentives for economic development purposes.

Some businesses avoid or reduce their income tax liability by the way in which they incorporate (e.g. limited liability partnerships are subject to the individual income tax, not the corporate income tax). Some companies with multiple locations shift income to a holding company in another state or country with a low tax burden. Some analysts argue that with interstate competition and the political power of large corporations, it is not possible to apply the corporate income tax effectively, fairly, and efficiently at the state level. Others think the corporate income tax should be restructured so that it is broad based with low tax rates.

REVENUE SYSTEM GUIDING PRINCIPLES

The guiding principles listed below were developed based on multiple inputs, including a literature review of reports such as those described above, the principles identified by “Fiscal 2000” (a study of Arizona’s fiscal system conducted in 1989), drafts of the Citizens Finance Review Commission (CFRC) guiding principles, and comments made at CFRC Technical Advisory Committee meetings. The CFRC also studied Arizona’s fiscal system, in 2003, as discussed in Chapter 12.

While agreement exists nationally regarding the guiding principles, the list of principles can be organized and grouped in a number of ways, and the terminology and definitions of terms can vary. Thus, the 10 principles listed below, which are ordered from the broadest considerations to more micro concepts, differ in terminology and number from the nine principles identified by the NCSL.

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

- Multiple revenue sources should be employed, including taxes, user fees, and federal revenues. Income, wealth, consumption, and transactions all should be taxed.
- An adequately funded budget stabilization fund should be used to offset the inevitable cyclical fluctuations in revenues. (See Chapter 17 for details on such a fund.) If revenues in a year exceed expenditures and the predetermined payment into the budget stabilization fund, the excess should be placed in the budget stabilization fund, another rainy-day fund, rebated, or expended for a one-time purpose. Permanent changes to the tax code should not be made nor should ongoing spending be increased.

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

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

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

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

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

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

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

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

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

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

Each of these 10 guiding principles is specific to the revenue system. However, revenues cannot be examined independently from the rest of the fiscal system—expenditures and debt. Additional guiding principles apply to a fiscal system. In particular, revenues and expenditures should be linked; this principle is sometimes labeled as **Accountability**:

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

EVALUATION OF ARIZONA’S REVENUE SYSTEM RELATIVE TO THE GUIDING PRINCIPLES

The February 2003 issue of *Governing* magazine rated the states’ revenue systems in three categories:

- **Adequacy of revenue.** Revenues should be reliable, come from balanced and multiple sources, be responsive to structural changes in the economy, be competitive in comparison to other states, and be adequate in both the short term and long term.

- Fairness to taxpayers. The revenue system should consist of broad revenue bases with low rates and few exemptions, be progressive, and treat similar taxpayers equitably.
- Management of system. The revenue system should feature a simple and visible tax code that facilitates taxpayer compliance, be fairly and efficiently administered, provide data and analytical capabilities; and be subject to accurate revenue projections.

On each measure, Arizona received a rating of 2 on a four-point scale (where 4 is best). *Governing* described this rating as “The state could continue to function as it currently does into the foreseeable future. But there are clear elements to the tax system that would benefit from change.”

The 2008 version of “Grading the States” published in *Governing* evaluated state governments in four categories: information, people, infrastructure, and money.⁵ Arizona received a C+ grade in the money category, which consists of five subcategories. Arizona received a mid-level grade on four: long-term outlook; budget process; contracting and purchasing; and financial analysis and reporting. Its structural balance was rated as a weakness.

Qualitative Assessment

Based on the literature review and data analysis, a qualitative assessment was made of how well each of Arizona’s larger tax sources currently compare to each of the guiding principles. A weighted sum (based on share of total revenue contributed by each source) of these evaluations resulted in the qualitative assessment of the overall system shown in Table 11.1. Arizona’s current revenue system receives a poor evaluation relative to a system of best practices on several of the guiding principles: stability, predictability, responsiveness, efficiency, competitiveness, neutrality, horizontal equity, vertical equity, and simplicity. In addition, the

Table 11.1
A Qualitative Assessment of the Overall Revenue System
as Currently Structured in Arizona

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

* Relative to a system of best practices.

fiscal system receives a very poor rating on accountability, given the structural deficit, lack of linkage between changes in revenues and changes in expenditures, and inclusion of capital expenditures in the operating fund.

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

Tables 11.2 through 11.4 provide a qualitative assessment of each of the three major tax sources and evaluate each as potentially improved. The general sales tax currently compares least favorably and has the greatest potential for improvement. In contrast, there is not much room for improvement in the individual income tax.

Table 11.2
A Qualitative Assessment of the General Sales Tax in Arizona

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

* Relative to a system of best practices.

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

In addition, strengthening the budget stabilization fund by increasing the amount that can be placed into the fund and by making transfers to and from the fund strictly formula driven, not subject to appropriation, would greatly enhance stability and predictability of revenue flows. Cyclical deficits could be eliminated.

Table 11.3
A Qualitative Assessment of the Property Tax in Arizona

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

* Relative to a system of best practices.

Figure 11.4
A Qualitative Assessment of the Personal Income Tax in Arizona

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

* Relative to a system of best practices.

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¹ This chapter is a shortened and updated version of a report prepared for the Citizens Finance Review Commission, *Preliminary Examination of Arizona's Governmental Revenue System* (2003), <http://www.azcfr.gov> under "Documents & Resources" and "What the Commission is Reading."

² National Governors Association and National Conference of State Legislators, *Financing State Government in the 1990s* (1993).

³ National Conference of State Legislators, *Principles of a High-Quality State Revenue System* (June 2007), <http://www.ncsl.org/default.aspx?tabid=12673>.

⁴ Katherine Barrett et al., "The Way We Tax: A 50-State Report," *Governing* (February 2003), <http://www.governing.com/gpp/2003/gp3intro.htm>.

⁵ Katherine Barrett and Richard Greene, "The Mandate to Measure," *Governing* (2008), <http://www.governing.com/gpp/2008/index.htm>.

Chapter 12

CITIZENS FINANCE REVIEW COMMISSION

Leezie Kim
Citizens Finance Review Commission

KEY POINTS

- The CFRC produced a plain English, user-friendly report on Arizona tax policy written by people who managed the long-term fiscal health of Arizona’s largest and strongest businesses, nonprofit organizations, and communities.
- The CFRC made several recommendations regarding the general sales tax: broaden the base to include certain services, while lowering the tax rate; reduce the number of exemptions; and create a more uniform tax base and rate across local governments.
- With regard to property tax, the CFRC recommended a number of changes: re-enact the state tax, eliminate residential subsidies, and apply uniform assessment ratios.
- The CFRC supported a reduction in a select number of personal and corporate income tax credits.
- To address the state’s tax structural weaknesses, the CFRC recommended strengthening the rainy-day fund, linking revenues and expenditures, and eliminating the supermajority requirement to raise taxes in the Legislature.
- A number of other recommendations were made by the CFRC; the total number was 36, most of which are as relevant today as when the CFRC met six years ago.

INTRODUCTION TO THE CFRC

The purpose of the Citizens Finance Review Commission (CFRC) was to “develop a series of recommendations that will advise the Governor on a course to stimulate Arizona’s economy for the long term. In particular, the Commission will develop recommendations that address fiscal and tax policies that are simple, low and fair and support Arizona’s growing economy.”¹

The CFRC was an experiment in policy making. Led by Bill Post, then Chairman of Pinnacle West, and Tony Astorga, Chief Financial Officer of Blue Cross/Blue Shield of Arizona, the CFRC was composed of 21 of the leaders of Arizona’s strongest businesses, its accounting firms, academia, its Native American communities, and large nonprofit social service organizations. None of the 21 members were elected officials. Among this “Jedi” council were the individuals responsible for the long-term financial health of their respective companies, clients, and communities. Governor Napolitano asked them to focus those skills on examining the long-term structural health of the Arizona revenue system. No member received any compensation. No member ever sent a delegate to the meetings. For a year, the team met in the open for four-hour-long meetings every three weeks.

Aided by Arizona’s state universities, volunteers from some of the big-four accounting firms, and volunteer tax and finance specialists from across the political spectrum who peer reviewed each other’s work, the CFRC produced reports that analyzed each aspect of the

state's revenue structure and wrote those reports in plain English, for nontax policy readers. The result was "A Fiscal Toolbox," published in January 2004, parts of which were republished in national tax publications and are still referenced today.²

RECOMMENDATIONS OF THE CFRC³

The CFRC made 36 recommendations (see Table 12.1). Most are as timely today as they were when written nearly six years ago. All dealt in some way with the revenue system of the Arizona state government. All recommendations were developed under an assumption of revenue neutrality—the CFRC made no recommendation whether overall revenues should be increased or decreased. In fact, the level of desired revenue has little, if any, effect on the design of a revenue system.

While 90% of the public conversation about taxes is around adequacy, the CFRC's analysis was more comprehensive. The stability of revenues over time was an important consideration, but this was just one of many factors considered by the commission—all of the guiding principles discussed in Chapter 11 were weighed.

The commission found a number of shortcomings in the state's revenue system, independent of the amount of desired revenues. In particular, the general fund relies predominantly on the income tax and the transaction privilege tax (sales tax); sales tax revenue across the country is shrinking or failing to grow at the pace of the rest of the economy due to a narrow and outdated tax base; Arizona's transaction privilege tax system is intensely complex to administer; the transaction privilege tax has many, many exemptions; the property tax system favors and subsidizes residents in numerous ways; and the income tax system has numerous tax credits.

Most tax analysts argue that changes in tax policy should not be done piecemeal. The revenue system needs to be considered in totality and adjusted as a whole. Every change affects a host of other taxpayers and policies. For example, when Nevada undertook a major study of tax policy in 2002, the task force placed all of its findings into one package that was intended to be introduced as one legislative bill.

In the following discussion, the CFRC's recommendations have been organized primarily by revenue source. Multiple recommendations were made regarding each of the major tax sources.

Transaction Privilege (Sales) Tax

The means by which wealth is generated and the ways in which income is expended have changed substantially since the 1930s. In particular, manufacturing and consumption of goods have proportionately decreased in favor of services. Interstate and international trade has increased. Consumer purchases from catalogs and the Internet have increased. Yet the structure of the state's sales tax remains nearly the same as in the 1930s.

Broaden the Sales Tax Base

The National Convention of State Legislators (NCSL) and National Governors Association (NGA) have long recommended that states expand the sales tax base to include services as

Table 12.1
Summary of Recommendations of the Citizens Finance Review Commission

- 1 Move toward reducing overall business property tax burdens.
- 2 Reduce the business personal property tax on locally assessed business personal property.
- 3 Apply a uniform assessment ratio on all future voter-approved property tax funded bonds and overrides.
- 4 Align the TPT to more appropriately mirror the state's economy by expanding the tax base.
- 5 Carefully examine the effectiveness of the possessory interest tax to determine if it is functioning the way it was intended, i.e. an in-lieu property tax.
- 6 Assign the specific responsibility for long-term planning to a particular agency or committee.
- 7 In addition to the current practice of cost accounting, utilize accrual accounting on a selective basis to provide the state's financial policymakers with long-term planning budget data.
- 8 Centralize information about federal funds in an effort to increase the federal grant dollars received.
- 9 Increase the current limit on the budget stabilization fund to its original 15% cap and take measures to make "raids" on the fund more difficult.
- 10 Utilize capital financing tools (bonding) for long-term capital assets with debt service tied to specific revenue streams.
- 11 Establish high-level tax policy guidelines to be used to test the soundness of future proposed transaction privilege tax exemptions.
- 12 Do not depend on general fund revenues to finance new school construction, but instead implement a process for new school construction using local school district, county, or state property taxes.
- 13 Where possible, phase in major changes—or phase out changes—to the tax structure over time.
- 14 Remove the constitutional requirement that raising tax rates requires two-thirds affirmative vote, reverting to a simple majority requirement.
- 15 Hire a consultant to examine the fairness and extent of miscellaneous taxes and fees imposed by the state for services.
- 16 Decrease revenue loss by increasing spending on revenue enforcement until cost-benefit equilibrium is reached, and implement a system that makes tax avoidance more difficult.
- 17 Replace unit-based fees and taxes with percentage-based fees and taxes.
- 18 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.
- 19 Have as few corporate and personal income tax credits as possible.
- 20 Follow the federal income tax returns as much as possible.
- 21 The cities and state should pursue greater transaction privilege tax uniformity.
- 22 Include a sunset provision to each transaction privilege tax exemption to periodically compare the public policy supporting the tax exemption against the evolving state of the state.
- 23 Do not adopt a gross receipts or expanded franchise tax as a replacement for corporate income tax.
- 24 Phase out the homeowner's rebate.
- 25 Do not reinstate the "throwback rule" in the corporate income tax calculation.
- 26 Continue to impose the estate tax on the amount that is equal to the state tax credit provided for in the federal tax code even though the credit is scheduled to be phased out.
- 27 Do not adopt a real estate transfer tax.
- 28 Re-enact the option of a state property tax, applied on a uniform assessment ratio.
- 29 Broaden the transaction privilege tax base by including "personal" services or "consumer" services.
- 30 Broaden the TPT tax base by including certain transactions that currently are tax exempt.
- 31 Withhold income tax from nonresidents.
- 32 Retain certain low-income tax credits.
- 33 In conjunction with eliminating certain exemptions and broadening the transaction privilege tax base, lower the rate accordingly.
- 34 Eliminate the 1% constitutional cap on residential property tax.
- 35 Review the effectiveness of private-school tuition tax credits and the extracurricular public-school tax credit.
- 36 Do not adopt a single flat rate for personal income tax purposes.

Source: Citizens Finance Review Commission, *A Fiscal Tool Box* (January 2004), <http://www.azcfr.com> under "Documents & Resources."

well as goods.⁴ While taxing most services is desirable, the NCSL and NGA noted that business services should be excluded since the sales tax is a tax on consumers and should not be applied to components of production (which would create a double taxation situation). In addition, the NCSL supported removing the popular sales tax exemption on groceries, describing it as an “expensive way to benefit the poor since affluent people receive a greater gain.” More recently, other groups have continued the call to expand the sales tax base to include certain services.⁵

The CFRC supported the idea of aligning the state transaction privilege tax base to more appropriately mirror the state’s economy by expanding the tax base to include some services. To determine which services, the commission weighed the practicalities of administrative ease, competitive effects, and the likelihood that the consumer would attempt tax avoidance by purchasing the service in another state. Studying the experiences of other jurisdictions, the commission determined that certain services—often called “consumer” or “personal” services—should be included in the tax base.⁶ These services are consumed by the ultimate end user, are not likely to be purchased in another state to avoid taxation, and generally have an obvious site of the transaction (for administrative ease). Examples include dry cleaning, personal grooming services, automobile tune-ups, dating services, and massages.

Broadening Arizona’s transaction privilege tax base by taxing services would have the effect of enhancing the revenue system’s stability, responsiveness, and predictability. The CFRC suggested that by expanding the transaction privilege tax base, the state could lower the state’s relatively high tax rate, promoting efficiency, competitiveness, and vertical equity.

Reduce the Number of Exemptions

The CFRC specifically identified 220 separate exemptions to the transaction privilege tax base written into the Arizona statutes as of 2003 (as discussed in Chapter 3), creating a Swiss cheese-like tax base. The commissioners agreed that there were too many exemptions in the transaction privilege tax base, and recommended that each exemption be examined by a review team. Further, the CFRC recommended all transaction privilege tax exemptions be subject to sunset provisions that would require public policymakers to periodically compare the public policy supporting the tax exemption—there are some widely accepted public-policy reasons for certain sales tax exemptions—to the evolution of the state.

In conjunction with eliminating certain exemptions and broadening the tax base, the CFRC recommended lowering the transaction privilege tax rate.

Develop a More Uniform Transaction Privilege Tax Base

The Arizona Tax Research Association, one of the most prolific tax policy analysis organizations within the state, pointed out the need for more uniformity in the state and municipal sales tax base.⁷ Localities have the power to impose a level of transaction privilege tax in addition to the state’s 5.6% transaction privilege tax and can customize their tax base, using their own definition of taxable and exempt transactions. The CFRC agreed that cities and the state should pursue greater tax uniformity.

Businesses that collect the sales tax must adhere to a complex transaction privilege tax system that is different from city to city. Imagine the complex tax collection system with which a chain retailer such as Target must contend: applying different tax rates on the same product from city to city and taxing food and certain other items in some cities but not in others. Not only will greater uniformity simplify the transaction privilege tax system and lower the cost of compliance, it will be the first step in moving the state toward compliance with a movement to create a uniform interstate sales tax system that would make it possible to begin taxing Internet sales of goods. But, resistance is high since this type of uniformity comes at the price of loss of local control.

The University of Tennessee estimated the sales and use taxes not collected on electronic commerce by state in 2007.⁸ The estimated amount in Arizona was \$235.2 million, or 3% of the entire sales tax due. This percentage was sixth highest in the country and second highest among nine western states. Had the percentage been a more typical 2.5% instead of 3%, the state would have realized an additional \$39 million in revenue.

The movement to create legislation that would allow states to collect taxes on Internet-based sellers of goods is called the streamlined sales tax agreement.⁹ Twenty-two states have adopted the tax simplification measures in the agreement.

In a description simplified to crudeness for the sake of brevity, the streamlined sales tax agreement is a way states could voluntarily agree to allow taxation of sales that states could not otherwise tax because the states do not have legal jurisdiction over buyers and sellers in other states. One of the key procedural requirements of the streamlined sale tax agreement is that states would have to agree to a uniform sales tax base throughout the state. Arizona's transaction privilege tax system is so customized from city to city that proponents of the streamlined sales tax agreement say Arizona is one of the three states that would undergo the most dramatic changes by enacting a uniform tax base. Traditional brick-and-mortar businesses support the streamlined sales tax agreement for reasons of simplicity and because the current tax system requires local bookstores, for instance, to collect sales tax but does not require Amazon and other Internet-based companies to collect or remit sales tax.

Income Tax

While several CFRC recommendations applied to either the personal income tax or the corporate income tax, most were of the nature of not recommending a suggested change or of recommending the continuance of existing policies. The exceptions were three recommendations related to income tax credits.

Until 1981, there were no corporate income tax credits in Arizona. The number of corporate income tax credits began rising quickly in 1996. Some argue tax credits are a fiscal tool to influence corporate behavior. Critics argue that tax credits have little or no influence over business decisions, reduce government revenue, and complicate the tax code.

The CFRC investigated Arizona's various corporate tax credits, the policy goals they were supposed to attain, and the frequency of their use by corporate taxpayers. Based on that investigation, the CFRC determined that all corporate tax credits should be reviewed

periodically and recommended that all but the following credits that were available in 2003 should be phased out: research and development, enterprise zones, defense restructuring, school site donation, and technology training.¹⁰

As of 2003, there were at least 20 individual income tax credits in Arizona's tax code, yet at least eight were claimed by fewer than 10 income tax filers in 2000. Applying the same analysis used for corporate tax credits to individual income tax credits, the CFRC suggested phasing out all but the following individual tax credits that were available in 2003: clean elections (because it is ballot approved and cannot be altered except by public vote), family tax credit, property tax credit for low-income seniors, private-school tax credit, and extracurricular activity public-school tax credit.¹¹ The continuance of the two tax credits related to schools was recommended for further study.

The number of income tax credits varies over time. Currently, 31 individual income tax credits are listed in statute (Title 43, Chapter 10, Article 5). Twenty-one corporate income tax credits are listed in Title 43, Chapter 11, Article 6. Some of these can be claimed only on carry-forward amounts.

Property Tax

The state property tax was revoked in 1996, eliminating the most stable source of revenue for the general fund. (The property tax continues to be assessed by most local governments and is administered by the counties.) The CFRC recommended that the option of a state property tax be re-enacted. However, the recommendation specified that the state property tax should be applied using a uniform assessment ratio for all classes of properties.

Property taxes are determined based on property value and an assessment ratio that varies across nine property classes. Most businesses have an assessment ratio more than twice that of residential homeowners. The CFRC recommended that the current classifications that apply a higher assessment ratio to businesses than to residential homes be simplified so the same assessment ratios apply regardless of the use of the real property.

In a myriad of ways, Arizona's property tax system favors residential owners over business owners. The first three CFRC recommendations addressed the reduction of business property taxes and applying a uniform assessment ratio. The business property tax is discussed in the next chapter.

Phase Out the Homeowner's Rebate

As most new residents to the state quickly recognize, residential property taxes in Arizona are remarkably low. One way the state has subsidized residential homeowners is the homeowner's rebate. Most residential homeowners are probably unaware that in 2009 every residential homeowner's primary property tax bill was automatically reduced by 39%, up to a dollar limit of \$580. Originally, the homeowner's rebate was designed to provide assistance to low-wage households. But it is a subsidy that is applied to all homeowners irrespective of wealth and is largely unknown by the public.¹² The burden of the lost tax revenue is shifted to the remainder of the real property tax base, and felt most by business property owners. The CFRC recommended that the homeowner's rebate be phased out.

Eliminate the 1% Constitutional Cap on Residential Property Tax¹³

Many residential homeowners are unaware that they receive a 1% constitution cap on the primary property tax they pay (see Chapter 8). This residential property tax cap affects almost all other property tax reforms. The cap acts as an artificial ceiling on the primary property tax and is applied only to residential property owners. The cap has frustrated state tax policy administrators who recognize the “disconnect” it creates between the spending decisions of local government and the residents’ burden of bearing the cost of local government spending. This is particularly true for residents in districts that have already hit the 1% cap and know they will not have to pay for any further spending. Instead, the additional expenses are absorbed by business taxpayers and the general fund.

The CFRC recommended that this cap be eliminated. Some CFRC commissioners recommended replacing the 1% cap with an income tax credit or a rebate for property taxes paid by low-income residents.

Fees for Government Services

The vast majority of Arizona state government general fund revenue comes from tax sources. User fees are among the minor sources of revenue. Fees are used more extensively in many states.

The CFRC felt that fees charged for services need to reflect the fair market value of the services provided, or at least cover the real cost of providing the services. Although some regulatory agencies cover their own costs through fees collected from the groups they regulate or serve, many do not. The result is that some groups receive services subsidized by the taxpayers. For example, every corporate lawyer in Arizona recognizes that Arizona undercharges for the services of the corporation commission’s incorporation (\$60) and maintenance fees (\$45 annually) and that the speed of the services provided is woefully behind the services provided by states that charge higher fees, like Delaware.

Naturally, agencies that provide welfare services do not have an opportunity to charge adequate user fees. Welfare-oriented services are charged at below-market or no cost. Other services could be charged at fair-market value and subsidize the welfare-oriented services. The CFRC recommended that further study be done on miscellaneous taxes and fees.

Recommendations Not Specific to Taxes or Fees

Since the CFRC took a comprehensive look at the state’s revenue system, many of its recommendations were not specific to a particular tax or fee.

Link Revenues and Expenditures

Budget managers, whether for a government, a business, or a household, all know to match revenue types to expenditure types. In general, long-term spending patterns should be matched to long-term revenue patterns, short-term spending should be tied to short-term revenues, and one-time spending handled by one-time revenues. Individuals pay for groceries with immediately available funds, but finance the purchase of their homes. Businesses pay for wages with ready cash, but finance new building construction. Many budgetary analysts recommend states follow this example and finance, through bonding, long-term capital assets

with debt service tied to specific, long-term, recurring revenue streams. Two CFRC recommendations addressed this issue.

Budget analysts also generally agree that implementation of new government programs and expansion of existing programs should not be allowed without making a commensurate change in the revenue system to provide the funding needed. This assures the public consider the cost of the services it demands and makes a rational cost-benefit analysis. (In 2004, Arizona voters instituted by ballot initiative the requirement that initiatives proposing new programs must include a designated revenue source.) Similarly, tax cuts should not be allowed without spending reductions being made at the same time (or offsetting revenue enhancements being implemented).

Strengthen the Budget Stabilization Fund

Almost all analysts who have studied Arizona's tax policy agree that Arizona's tax revenue is highly cyclical and follows the cyclical pattern of the national economy. A number of the CFRC's recommendations—most notably, the broadening of the sales tax base, the increased reliance on residential property taxes, and greater use of user fees—will have the effect of reducing the cyclical instability in state government revenues. But considerable cyclicity will remain. Because no regulatory policy can change the state economy's sensitivity to the national economic cycle, most tax policymakers address how to be prepared for the inevitable fluctuations.

Nearly all tax and budget analysts support a strong and well-funded "rainy-day fund" (called the budget stabilization fund—BSF—in Arizona). Monies are deposited into the rainy-day fund during times of strong economic growth and surplus revenues and are withdrawn during the inevitable periods of economic downturn that reduce tax collections. When Arizona's BSF was originally created in 1990, the fund was capped at 15% of the general fund budget. But in 1995, state policymakers lowered the BSF cap to 5% of the general fund budget. Instead of depositing monies into the BSF as specified in the original legislation, permanent tax cuts were instead implemented. Later, the cap was raised to its current 7%, but a fund of this size did not provide nearly enough monies to offset the cyclical loss of revenue in each of the subsequent two recessions.

In addition to the inadequate size of the fund, monies have been removed from the BSF for purposes other than budget stabilization. Thus, the CFRC recommended both that the higher cap be restored and that "raids" on the fund be made more difficult. The BSF is discussed in more detail in Chapter 17.

Procedural and Miscellaneous Other Suggestions

Among the other CFRC recommendations was the replacement of unit-based fees and taxes with percentage-based fees and taxes. For example, many of the selective sales taxes, such as those on alcoholic beverages and gasoline, are at a fixed dollar figure per quantity purchased, which does not adjust for the effects of inflation.

Several CFRC recommendations addressed procedural issues, including enhancing the state's long-term planning, using accrual accounting as well as cost accounting, centralizing

information on federal funds in an effort to increase federal grant dollars, increasing revenue enforcement, and maximizing interest earnings. Finally, the CFRC also recommended that the two-thirds requirement to pass a tax increase be returned to a simple majority vote.

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¹ Citizens Finance Review Commission, <http://www.azcfr.com/index.asp>.

² Citizens Finance Review Commission, *A Fiscal Tool Box* (January 2004), <http://www.azcfr.com> under "Documents & Resources."

³ This section is an update to a portion of Chapter 7, "Aligning Arizona's Tax Structure to Meet Our State's Rapid Growth," in the 89th Arizona Town Hall background report, *Arizona's Rapid Growth and Development: People and the Demand for Services* (2006).

⁴ National Governors Association and National Conference of State Legislators, *Financing State Government in the 1990s* (1993).

⁵ See for example, Center on Budget and Policy Priorities, *Faulty Foundations: State Structural Budget Problems and How to Fix Them* (May 2005), <http://www.cbpp.org/files/5-17-05sfp.pdf>, and Institute on Taxation and Economic Policy, *Should Sales Taxes Apply to Services?* (Policy Brief #3, 2008), <http://www.itep.net.org/pb3serv.pdf>.

⁶ Citizens Finance Review Commission, Transaction Privilege Tax Research Committee, *Transaction Privilege Tax: Expansion of Transaction Privilege Tax to Services* (2003), <http://www.azcfr.com> under "Research Reports."

⁷ Kevin McCarthy, representing the Arizona Tax Research Association, "Presentation to the Citizens Finance Review Commission" (2003), <http://www.azcfr.com> under "What the Commission is Reading."

⁸ Donald Bruce, William Fox, and LeAnn Luna, State and Local Sales Tax Revenue Losses from Electronic Commerce, (University of Tennessee, April 13, 2009), http://www.streamlinedsalestax.org/Executive%20Committee/Previous_meetings/4_13_09/SSTP%20e-commerce%202009%20REV041309.pdf.

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¹⁰ Citizens Finance Review Commission, Income Tax Research Committee, *Income Tax: Examination of Corporate Income Tax Credits* (2003), <http://www.azcfr.com> under "Research Reports."

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¹² Citizens Finance Review Commission, Property Tax Research Committee, *Property Tax: Eliminate the Homeowner's Rebate* (2003), <http://www.azcfr.com> under "Research Reports."

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Chapter 13

BUSINESS TAXES

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KEY POINTS

- The most compelling economic reason to tax businesses is the “benefits principle” of public finance: businesses and individuals should be taxed to pay for the public services they use.
- In every state of the nation, state and local government taxes imposed on businesses substantially exceed any reasonable measure of the public services provided to them. Business taxes in Arizona were estimated to be 64% higher than public expenditures on programs that benefit businesses in 2006.
- Businesses are therefore subsidizing public service delivery to households. State and local government tax policy would be brought more in line with the benefits principle if some of the burden of financing public expenditures were shifted from businesses to households.
- Business taxes appeal to politicians because they have low visibility among voters, who generally believe that such taxes are paid out of the pockets of business owners. Many citizens are unaware that some local business taxes are shifted to them in the form of higher product prices or lower wages. This political appeal best explains why business taxes are as high as they are in Arizona and other states.
- Among general business taxes in common use, the corporation income tax may be the least consistent with the benefits principle. More suitable would be a combination of taxes on business property and payroll.
- In 2008, Arizona state and local governments collected \$10.2 billion from business taxes, which accounted for half of all tax collections—a higher-than-average share. When measured as a proportion of state private-sector gross domestic product, business taxes in Arizona were just less than the average for all states.
- Arizona’s business tax collections disproportionately came from the sales tax in 2008. Collections from the property tax were near average, but each of the other business taxes was lightly used.
- To best implement the benefits principle in general business taxation, Arizona would rely less heavily on corporate income taxes and sales taxes and more heavily on payroll taxes.

DEFINITION OF BUSINESS TAXES

Business taxes can be defined as taxes imposed on the purchase, ownership, or use of inputs in a productive activity. In addition to federal taxes, such as payroll taxes for Social Security and Medicare, businesses are potentially subject to a number of state and local government taxes:

- **Property:** Nationally, this is the largest source of business tax payments. Personal property (such as equipment) may be taxed as well as real property.

- **General sales:** The second-largest source of business tax payments nationally, sales taxes are applied to business purchases of equipment or materials. However, businesses in Arizona benefit from numerous exemptions from the sales tax. For example, articles to be incorporated into a manufactured product and wholesale goods are exempt from the tax.
- **Income:** Corporations pay a corporate income tax, but most businesses are not incorporated—their income taxes are paid through the individual income tax.
- **Business license.**
- **Unemployment insurance.**
- **Gross receipts:** These taxes often are paid in lieu of corporate income or property taxes. Taxes on insurance premiums and public utilities are examples.
- **Excise:** Selective sales taxes, such as the tax on motor vehicle fuel.
- **Other:** Severance taxes, levied on the extraction of natural resources such as oil, are one example. (Arizona has limited opportunities to impose severance taxes; this tax has become an insignificant source of revenue in the state in recent decades.)

Business taxes are a controversial component of the state and local government tax system and a frequent target of proposals for tax reform. This chapter reviews standard economic principles for judging the appropriateness of business taxes and evaluates Arizona’s business taxes in light of those principles.

THE PAYMENT OF BUSINESS TAXES

While businesses technically pay the various taxes levied upon them, the actual burden of business taxes may fall on a number of parties, including the business (paid out of business income), consumers (higher prices of goods and services), workers (lower wages), and owners of land (lower land values and rents). It is difficult to ascertain the final burden in all cases. In this chapter, a “business tax” refers to any tax whose initial incidence rests with business owners, even though the ultimate burden of the tax may fall on other entities. (Technically, Arizona’s sales tax is a transaction privilege tax paid by businesses, but the portion of the revenue collected from sales to individuals is not included in this chapter as a business tax.)

Taxes are just one of many business expenses that play a role in determining the price of a good or service. Many companies that sell goods and services to Arizona residents have a “captive” market—for example, a Phoenix resident is not going to travel to New Mexico to buy their groceries. Further, these companies are subject to the same state tax code. Under these conditions, a company generally is able to pass the expense of taxes to the consumer in the form of a higher price for their good or service.

In contrast, businesses that primarily sell to customers outside the state have difficulty recovering their local expenses (including tax payments) in higher prices because they are subject to international competition. If local business taxes are high, this may suppress the number of business facilities located in the area, which in turn may hold down land prices and/or wages. However, if lower costs in wages or rents are not sufficient to offset a high business tax burden, an exporter may simply choose not to locate in an area.

RATIONALE FOR BUSINESS TAXES

Four alternative explanations for taxing businesses are considered in this section.

Political Explanation

Many taxpayers believe that business taxes are simply paid out of the profits of shareholders, who are relatively few in number and may not even be state residents. As a result, business taxes generally meet with less voter resistance than do personal taxes, a point that has not been lost on politicians.

However, it is an old adage in public finance that taxes are ultimately paid by people. The payment of individual income and residential property taxes provides a clear measure of that portion of the tax burden. In contrast, most workers whose wages have been held down over time as the market's way of allocating the burden of a payroll tax, or most consumers who pay prices that are higher because of business taxes that are passed forward to them, do not realize that they are paying the burden of business taxes.

To the extent that the voting public systematically underestimates their actual burden, business taxes should be viewed as an inferior tax instrument. To make intelligent choices about the size and scope of government, citizens need to know the true cost of government. When costs of public services are concealed or underestimated, people will choose to support a larger public sector.

Ability to Pay

A common perception is that business taxes are paid by owners of firms, who generally are wealthy. Business taxes would then seem to be an effective instrument for carrying out progressive taxation.

While those who own businesses do have, on average, higher incomes than those who do not, many owners of small businesses are not wealthy, and many of the shareholders of corporations are middle-aged and elderly people, who became shareholders through the investments of their retirement plans. Some members of retirement plans are wealthy, but most are not. Further, in many cases the burden of business taxes is shifted away from owners to groups that cut across a range of income classes, including customers and employees of taxed businesses.

Given the vagaries of tax shifting and the wide distribution of business ownership in the general population, business taxes are too blunt to be relied upon to distribute taxes according to specific ability-to-pay principles. The individual income tax is a far more effective instrument for tailoring individual tax liabilities to particular personal circumstances.

Tax Exporting

Transferring the burden of state and local government taxes away from residents to nonresidents is a popular strategy. For example, sales taxes and bed taxes are common in areas with many tourists.

Severance taxes levied on mining companies represent the most important case of successful tax exporting by local jurisdictions. It is not surprising that states with substantial deposits of oil, natural gas, and coal rely heavily on severance taxes to fund local government. Minerals and fuels are sold in national and international markets. So the exporting of state severance taxes may occur through higher prices for out-of-state consumers and through lower incomes for resource owners who live outside of the taxing state.

Tax exporting also may be used as a rationale for taxing out-of-state business owners. However, this strategy may prove to be counterproductive if high taxes discourage companies from locating operations in the local area or if high taxes hold down wages.

Benefits Principle

William Oakland has argued that the most compelling reason to tax businesses is provided by the “benefits principle” of public finance.¹ Businesses should be taxed to pay for the public services rendered unto them. Having entities pay for the services they receive obviously meets standards of tax equity. But economic efficiency is also enhanced. When firms that use government services are taxed commensurately, the prices of the goods they produce more accurately reflect the full costs of production, enabling consumers to make better economic choices.

Theoretical models of interjurisdictional competition demonstrate the efficiency of taxing businesses in proportion to the value of public services they receive. In an early demonstration of this result, a model was used in which local jurisdictions competed for mobile business capital by providing government services to firms and households and taxing them to pay for the services.² The principal conclusion of this analysis is that, in a competitive environment, taxes on households and businesses become benefit taxes. The taxes households and businesses pay exactly equal the value each places on the goods and services they receive from government.

Communities that tax businesses in excess of the cost of the services provided to them create a disincentive for businesses to relocate or remain there, causing a loss of jobs and incomes for residents. These losses outweigh the benefits residents receive from having businesses subsidize their public services.

In contrast, if a community subsidizes businesses by taxing them less than the cost of the public services provided, the cost in terms of foregone tax revenues or higher public service costs to households outweighs the benefits of the jobs and wages that might be attracted to the community by the low business taxes.

Empirical studies have found a universal tendency for business taxes levied by state and local jurisdictions to exceed the value of public services provided to businesses. When businesses pay for more public services than they consume, households do not directly pay for as much of the public services that they use. This prevents households from accurately assessing the true cost of the services they receive from their state and local governments.

COMPARING THE TAXES BUSINESSES PAY WITH THE PUBLIC SERVICES THEY RECEIVE

The first estimates of the value of public services provided to businesses by state and local governments were based on data for 1992.³ The goal of the study was to compare the value of services received with the amount of taxes paid. Federal grants and user fees were first netted out of state and local government expenditures by function, leaving the remaining expenditures as funded from own-source (state and local government) tax revenues. These expenditures then were divided into four categories: business, household, shared, and prorated.

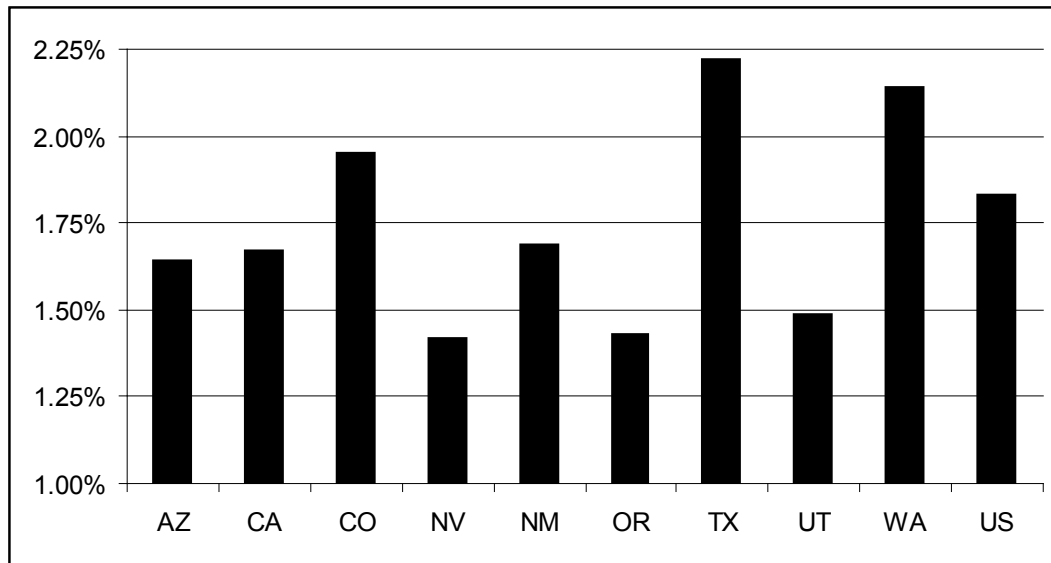
Business programs are those dedicated solely to businesses, such as agricultural programs and water transportation terminals. Household programs such as education, health and public welfare, parks and recreation, and housing, which accounted for 61% of total state and local government expenditures nationally, are assumed to benefit households only. Shared programs are those that benefit both businesses and households, such as police, fire, and highways. Given a lack of empirical data, one-half of these expenditures were assumed to benefit businesses and one-half to benefit households. Expenditures on programs consisting of government overhead functions were prorated between households and businesses based on the distribution of expenditures already classified.

Even after making these generous assumptions about the extent to which businesses benefit from shared programs, business taxes in every state were found to significantly exceed the value of public services received by businesses. For the nation as a whole, state and local government business taxes were 1.7 times the level of expenditures that benefited businesses.

These estimates have recently been updated.⁴ In the most recent study by Ernst & Young, one of the original assumptions was changed: rather than to consider education to be a household program, one-quarter of state and local government educational expenditures were allocated to businesses.⁵ In theory, education and training that is general rather than firm-specific enhances the productivity of the individual wherever the person works. The firm employing such a worker pays higher wages commensurate with the worker's higher productivity, but the burden of paying for the education falls on the individual. If education and training is firm-specific, on the other hand, the firm pays for the training but does not have to pay higher wages.

The results from the Ernst & Young study for the nation and nine western states, including Arizona, are shown in Figure 13.1. These results are broadly similar to those in the original study. Throughout the United States, business taxes significantly exceed state and local government expenditures on programs that benefit businesses. Nationwide, business taxes in 2006 were 83% higher than expenditures that benefit businesses. The gap between taxes and expenditures was lower in Arizona than the national average, with business taxes estimated to be 64% higher than public expenditures that benefit businesses. The western states with the closest match between taxes paid and benefits received were Nevada, Oregon, and Utah. But even in these states, business taxes were more than 40% higher than expenditures.

Figure 13.1
Ratio of Business Taxes to Government Expenditures That Benefit Businesses, Western States and United States, Fiscal Year 2006



Source: Ernst & Young.

The policy significance of these findings is that state and local government tax policy in Arizona, and indeed in all other states, could be brought more in line with the benefits principle of taxation if some of the burden of financing public expenditures were shifted from businesses to households. Businesses are currently subsidizing public services delivered to households. In a revenue-neutral adjustment, personal taxes would be increased to compensate for decreases in business taxes.

There is a limit to how far this process should go, however. It would be equally as inefficient for businesses to be taxed less than the value of the services they receive. Thus, care must be exercised in the use of tax incentives for businesses.

IMPLEMENTING BUSINESS TAXES IN ACCORDANCE WITH THE BENEFITS PRINCIPLE

In the case of firm-specific services, such as the extension of water and sewer lines to a manufacturing facility, the most direct and accurate way of implementing benefit taxes is through a user charge or special assessment. For services that are proportional to consumption of a particular commodity, an excise tax is an effective way of recovering costs. An example is a gasoline tax that helps pay for the cost of transportation services, which benefit businesses in proportion to their use of roads.

More problematic are cases where government services are consumed widely by the business community and it is difficult to measure the services received by any one firm. Examples include public administration, the legal system, police and fire protection, and public health. In these cases, public services should be financed with general business taxes. In choosing

between alternatives, Oakland suggests that taxes be used that broadly correlate with local productive activity and that are neutral with respect to the input decisions of firms and the consumption decisions of households.

Among business taxes currently used by states, Oakland finds the corporation income tax to be the least suitable. It clearly conflicts with the benefits principle. All firms engaged in productive activity make use of public services. Yet with the corporate income tax, only incorporated businesses that generate taxable income contribute to the cost of these services, and those with low taxable income do not pay their share. The corporate income tax also is not a neutral tax. Profits of unincorporated businesses are exempt, so the tax serves to encourage the growth of industries not well suited to the corporate form of business, that is, much of the service sector.

Oakland also considers sales and gross receipts taxes to be poor instruments for business taxation. These taxes are not as negative in cases in which the sales tax is not applied to intermediate transactions within the manufacturing process. Such transactions are exempt from the sales tax in Arizona.

Given the objections to the corporate income, sales, and gross receipts taxes, Oakland recommends that businesses pay for the public services they receive through a combination of payroll and real property taxes. Excessive reliance on only one of these taxes would create distortions. For example, if business taxes were collected only through property taxes, this would encourage firms to substitute labor for capital, and it would raise the relative price of capital-intensive goods. Other than for unemployment insurance, payroll taxes are not commonly used by state and local governments.

ARIZONA'S BUSINESS TAXES COMPARED WITH OTHER STATES

For each of the past seven years, Ernst & Young in conjunction with the Council of State Taxation have estimated state and local government business taxes for individual U.S. states.⁶ Their estimates of Arizona's business taxes in fiscal year 2008 are shown in Table 13.1. Total business taxes levied by Arizona state and local governments in 2008 amounted to \$10.2 billion.

The business taxes providing the most revenue in Arizona in 2008 were taxes on real and personal property and sales taxes. These two taxes accounted for 37% and 35%, respectively, of total Arizona business taxes. The business share of excise taxes and taxes on gross receipts accounted for 10% of total business taxes in the state. The state corporate income tax accounted for 8% of total business tax revenues. Other business taxes include employer contributions to unemployment insurance, business and corporate license taxes (including motor vehicle taxes), and individual income taxes paid by owners of sole proprietorships, partnerships, and S-corporations.

Property taxes are the most important source of business tax revenue in Arizona and the nation, accounting for a similar share of total business taxes. Sales taxes are the second-most important type of business tax in the state and the nation, but Arizona derived a much larger percentage of business tax revenues from sales taxes than did the nation. The larger share of

Table 13.1
Combined State and Local Government Business Taxes by Type of Tax,
Arizona and United States, Fiscal Year 2008

	Arizona (Billions)	Share of Total	
		Arizona	United States
TOTAL	\$10.2	100.0%	100.0%
Property	3.8	37.0	35.5
Sales	3.5	34.6	22.2
Excise and Gross Receipts	1.0	9.7	11.6
Corporate Income	0.8	7.7	9.6
Unemployment Insurance	0.3	2.9	5.5
Individual Income	0.2	2.0	4.6
License and Other	0.6	6.1	11.0

Source: Ernst & Young.

sales taxes in Arizona is offset by relatively smaller shares of business taxes derived from each of the other sources.

Nationwide, business taxes represented 44.1% of all state and local government taxes. Over the past 20 years, the business share of total taxes has been fairly steady. Among all states, Arizona's share ranked 15th highest in 2008 at 49.9%. States with the highest share of business taxes were Alaska (89.3%), Wyoming (74.3%), and North Dakota (65.3%). Each of these states relies heavily on severance taxes. The lowest business tax shares were in Maryland (30.7%), Connecticut (32.3%), and North Carolina (36.2%). The first column in Table 13.2 compares the business tax share in Arizona with other western states. Arizona tied for fourth highest among the nine states considered.

An alternative way of comparing the burden of business taxes is to measure the average effective rate of business taxation by dividing total state and local government business taxes by state private-sector gross domestic product (GDP). Nationwide, state and local governments taxed businesses in an amount equal to \$49 for every \$1,000 of state private-sector GDP in 2008. By this measure, Arizona ranked only 27th highest among the 50 states. States with the highest effective rate of business taxation were again Alaska (\$223), Wyoming (\$92), and North Dakota (\$89). States with the lowest average rate of business taxation were North Carolina (\$36), Connecticut (\$37), and Oregon (\$37). The second column in Table 13.2 compares the average effective business tax rate per \$1,000 of state private-sector GDP in Arizona with the rate in other western states. Arizona was fourth highest.

Arizona's business tax burden among all 50 states was high only on the sales tax (see Table 13.3). The business property tax in particular has been the focus of reform efforts in Arizona. While the Ernst & Young data indicate that this tax burden in Arizona was at the national average, it was second highest among the nine western states.

Table 13.2
Combined State and Local Government Business Tax Burdens,
Western States and United States, Fiscal Year 2008

	As a Share of Total Taxes	Per \$1,000 of State Gross Domestic Product
United States	44.1%	\$49
Arizona	49.9	47
California	40.7	46
Colorado	44.2	42
Nevada	49.9	46
New Mexico	56.1	60
Oregon	38.2	37
Texas	61.2	53
Utah	38.5	39
Washington	51.3	55

Source: Ernst & Young.

Table 13.3
Combined State and Local Government Business Tax Burden by Type of Tax,
Measured as a Percentage of Private-Sector Gross Domestic Product,
Arizona, Fiscal Year 2008

Tax	Difference From National Average	Rank Among 50 States*	Rank Among Nine Western States*
All Business Taxes	-4%	28 (tie)	4
Sales	49	9	2
Property	1	26	2
Excise and Gross Receipts	-18	30	7
Corporate Income	-21	29	4
Individual Income	-59	40	6
Unemployment Insurance	-48	45	8
License and Other	-48	38	8

* A rank of 1 indicates the highest (worst) tax burden.

Source: Ernst & Young.

A more in-depth look by the Minnesota Taxpayers Association reveals that the relative property tax burden was inconsistent across businesses in Arizona in 2008.⁷ For industrial properties with a low valuation, the property tax burden in Arizona ranked among the middle of the states, with the effective tax rate below the national average. In contrast, for industrial properties with a higher valuation, particularly for those with a high percentage of personal property (such as equipment used by high-technology manufacturers), the property tax burden in Arizona was among the 10 highest in the nation and was second highest among the nine western states. Similarly, the relative property tax burden for commercial properties in Arizona rose with valuation to among the highest in the nation and the highest among the

western states. The current phased-in reduction of business property tax assessment ratios should somewhat lower the tax burdens in Arizona relative to other states.

Arizona's method of taxing productive activity favors labor-intensive activities at the expense of capital-intensive ones. Large manufacturing establishments with substantial personal property—which includes most of the state's high-technology manufacturers—have a particularly high tax burden. Arizona tax policy would be better aligned with economic principles of business taxation if the state retained business property as an important tax base, but relied more heavily on payroll taxes and less heavily on corporate income taxes and sales taxes. However, given the extent to which business taxes in Arizona exceed the benefits principle, this conclusion does not preclude reductions in business property taxes as well, as in the high assessment ratio relative to residential properties.

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¹ William Oakland, "How Should Businesses Be Taxed?" in *State Taxation of Business: Issues and Policy Options*, ed. Thomas Pogue (National Tax Association, 1992), 17-34.

² Wallace Oates and Robert Schwab, "The Allocative and Distributive Implications of Local Fiscal Competition," in *Competition among States and Local Governments*, ed. Daphne Kenyon and John Kincaid (The Urban Institute, 1991), 127-45.

³ William Oakland and William Testa, "State-Local Business Taxation and the Benefits Principle," Federal Reserve Bank of Chicago *Economic Perspectives* (Jan/Feb 1996), 2-19, <http://www.chicagofed.org/publications/economicperspectives/1996/epjan96a.pdf>.

⁴ Rick Mattoon and William Testa, "How Closely Do Business Taxes Conform to the Benefits Principle?" (Federal Reserve Bank of Chicago, September 17, 2007), http://www.chicagofed.org/news_and_conferences/conferences_and_events/files/2007_tax_mattoon_testa.pdf.

⁵ Andrew Phillips, Robert Cline, and Thomas Neubig, *Total State and Local Business Taxes: 50 State Estimates for Fiscal Year 2008* (Ernst & Young, January 2009), [http://www.ey.com/Publication/vwLUAssets/Total_state_and_local_business_taxes:_50_state_estimates_for_fiscal_year_2008/\\$FILE/Total_state_and_local_business_tax_fiscal_year_2008.pdf](http://www.ey.com/Publication/vwLUAssets/Total_state_and_local_business_taxes:_50_state_estimates_for_fiscal_year_2008/$FILE/Total_state_and_local_business_tax_fiscal_year_2008.pdf).

⁶ See note 5.

⁷ Minnesota Taxpayers Association, *50-State Property Tax Comparison Study: Payable Year 2008* (April 2008), <http://www.mntax.org/research/property.php>.

Chapter 14

REVENUE SYSTEMS IN OTHER STATES

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KEY POINTS

- The revenue system in Arizona has been rated as mediocre, though typical of the western states. In contrast, neighboring Utah—a politically similar state—has been judged as having the best revenue system in the country.
- The structural imbalance of the state budget is rated as Arizona’s main weakness.
- Arizona’s tax burden is quite low from a national perspective, but is not much less than the norm of the western states.
- Western states are unusually dependent on the sales tax; Arizona utilizes this source more than most western states.
- Arizona’s use of nearly all other revenue sources is below the national average. It ranks particularly low, nationally and among the western states, on user fees and on taxes other than sales, property, and income.
- Changes in Arizona’s revenue system since the early 1990s have largely been inconsistent with those in other western states. Arizona’s dependence on the sales tax has increased the most; it is the only state to experience a decline in share from the income tax; and it has had one of the largest declines in property tax share.
- Compared to Arizona, Utah receives a much higher share of revenue from user fees and has more equal collections from the three major taxes.
- Based on various measures, Utah collects more revenue from its citizens than does Arizona.

COMPARISON OF ARIZONA TO OTHER STATES

The focus of this chapter is a comparison of Arizona’s state and local government revenue system to the systems used in other states, particularly eight other western states: California, Colorado, Nevada, New Mexico, Oregon, Texas, Utah, and Washington.

Rating of Revenue Systems

The February 2003 issue of *Governing* magazine rated the states’ revenue systems in three categories: adequacy of revenue, fairness to taxpayers, and management of system.¹ On each measure, Arizona received a rating of 2 on a four-point scale (where 4 is best). *Governing* described this rating as “The state could continue to function as it currently does into the foreseeable future. But there are clear elements to the tax system that would benefit from change.” Ratings of 1 mean that dramatic reform is needed; a 3 indicates room for improvement, but essentially good performance; and a 4 indicates very good performance.

Across all 50 states, a rating of 2 was most common in each category, with the majority of states receiving this score in the adequacy and fairness categories. As a group, the states scored worst on adequacy and best on management. While Delaware stood out by receiving

two ratings of 4 and one of 3, its high-quality system cannot be duplicated exactly in other states. State-to-state differences in economic structure, resources, demographics, and citizen attitudes mean that the ideal model will look somewhat different in each state.

Cumulating the ratings for the three categories, most states scored between 6 and 8. The comparison states as a whole did more poorly than the national average, with four receiving a score of less than 6—only eight states nationally received such low marks. Nevada was the only state to receive a grade of 1 in each category. California, Colorado, and Texas scored only 5. New Mexico and Utah did the best of the comparison states, with scores of 8. Adequacy is a particular problem among the comparison states, with seven scoring only 1—only 11 states nationally received this low mark. Thus, while *Governing* appraised Arizona’s revenue system as needing improvement in each category, the state’s ratings were in the middle of the comparison states.

The 2008 “Grading the States” published in *Governing* evaluated state governments in four categories: information, people, infrastructure, and money.² Of specific interest to this chapter are the state rankings based on the money category, which looked at the structural balance and long-term outlook of the state budget, examined whether the process of passing the budget is transparent, and assessed the state’s financial management activities.

The national average of the money performance grades was B-. Arizona received a C+ grade, equal to that of 11 other states, but higher than only eight states. Three other western states—Colorado, Nevada, and Oregon—also received a C+. The only western state with a lower rating was California. Utah was the only state in the country to receive an A grade. Washington was among four states earning an A- rating.

For Arizona, structural balance of the state budget was listed as the main weakness. *Governing* states that “to some extent, this was the side effect of an income tax cut passed by ebullient lawmakers in 2006. The tax structure is now dangerously dependent on sales taxes.”

Arizona had the largest budget deficit in the nation in fiscal year 2009.³ Projections indicate Arizona will have the second-largest deficit in both the current fiscal year (2010) and the following year. It also had large deficits in the last economic downturn.

Comparison of Revenue Systems

State-specific data on government finances are available from the U. S. Census Bureau.⁴ The combined state and local government revenue data for Arizona were analyzed in Chapter 9 and are compared to other states in more detail in this chapter. All of the data are presented by fiscal year, which runs from July 1 through June 30. The latest data are for 2006.

Revenues in the western states are compared based on the two standard measures: per capita and per \$1,000 of personal income (see Table 14.1). The majority of the western states collected less revenue than the national average in 2006 based on both measures, with tax collections particularly low. Property taxes were below average in all but one western state and income taxes generally were low. In contrast, the western states made heavy use of the sales tax.

Table 14.1
Combined State and Local Government General Revenue by Source, Western States and United States,
Fiscal Year 2006

	Per Capita										
	General Revenue	Own Source Revenue	Total Taxes	Property Taxes	General Sales Taxes	Selective Sales Taxes	Individual Income Taxes	Corporate Income Taxes	Other Taxes	Current Charges (User Fees)	Other Revenue
United States	\$7,352	\$5,831	\$4,020	\$1,208	\$949	\$437	\$903	\$178	\$345	\$1,126	\$685
Arizona	6,021	4,566	3,291	912	1,232	311	537	147	153	729	546
California	8,113	6,552	4,533	1,031	1,117	323	1,418	286	359	1,322	696
Colorado	6,913	5,783	3,649	1,116	1,017	300	902	97	217	1,336	798
Nevada	6,764	5,788	3,984	1,024	1,355	990	0	0	615	1,059	746
New Mexico	7,967	5,848	3,615	495	1,280	383	583	196	680	862	1,370
Oregon	6,988	5,508	3,388	1,007	0	295	1,513	134	441	1,339	780
Texas	6,265	4,921	3,275	1,405	974	501	0	0	395	954	692
Utah	6,605	5,222	3,258	738	952	352	896	137	183	1,364	600
Washington	7,279	5,889	3,981	1,093	1,868	569	0	0	450	1,363	546
	Per \$1,000 of Personal Income										
United States	\$205.89	\$163.30	\$112.58	\$33.82	\$26.58	\$12.24	\$25.30	\$4.99	\$9.65	\$31.54	\$19.18
Arizona	190.41	144.39	104.07	28.83	38.95	9.83	16.98	4.65	4.83	23.06	17.26
California	209.66	169.31	117.16	26.63	28.87	8.35	36.65	7.38	9.28	34.16	18.00
Colorado	179.39	150.07	94.69	28.97	26.39	7.78	23.41	2.52	5.62	34.68	20.71
Nevada	177.74	152.09	104.68	26.90	35.60	26.01	0.00	0.00	16.17	27.81	19.59
New Mexico	278.87	204.68	126.53	17.31	44.80	13.40	20.39	6.84	23.78	30.19	47.96
Oregon	214.80	169.30	104.15	30.94	0.00	9.06	46.50	4.11	13.53	41.17	23.98
Texas	183.12	143.84	95.72	41.06	28.48	14.63	0.00	0.00	11.56	27.88	20.24
Utah	230.97	182.59	113.93	25.81	33.29	12.30	31.32	4.79	6.41	47.68	20.98
Washington	194.70	157.53	106.47	29.23	49.97	15.23	0.00	0.00	12.04	36.46	14.60

Source: U.S. Department of Commerce, Census Bureau, *State and Local Government Finances*.

Arizona's ranks in 2006 among the nine western states and among all 51 'states' (including the District of Columbia) are shown in Table 14.2. (The ranks among the nine western states are hardly different using 2005 data, with Arizona ranking one place higher in some categories.) On a per capita basis, Arizona ranked second lowest on general revenue and fourth lowest on own-source revenue in the nation, and last among the western states. In most categories, Arizona ranked in the bottom half. The general sales tax was the notable exception. Since Arizona's per capita personal income is considerably lower than the national average, its ranks generally are not quite as low per \$1,000 of personal income.

Arizona's relative uses of the various tax sources in 2006 are compared to the national average and to the other western states in Table 14.3. Variations in per capita collection of taxes are not considered in this table, which simply compares the shares of total taxes. Only two of the western states utilized the property tax as much as the national average; Arizona's below-average share was typical of the western states. In contrast, the general sales tax accounted for a higher-than-average proportion of tax revenues in each western state that used this tax. The only western state with a greater dependence on the general sales tax than Arizona was Washington. The individual income tax was the third major source of tax revenue nationally, but three western states did not levy this tax and two others, including Arizona, received a relatively low share of tax revenue from this source.

The sales, property, and income taxes accounted for more than three-fourths of the tax revenue nationally. Thus, all other taxes combined generally accounted for a relatively small

Table 14.2
Arizona's Rankings Among All States and Nine Western States,
Combined State and Local Government Revenue, Fiscal Year 2006

	Rank Among All 51 'States'*		Rank Among Nine Western States**	
	Per Capita	Personal Income***	Per Capita	Personal Income***
TOTAL GENERAL REVENUE	50	39	9	6
OWN-SOURCE REVENUE	47	45	9	8
Total Taxes	37	40	7	7
Property Taxes	36	33	7	5
General Sales Taxes	10	8	4	3
Selective Sales Taxes	43	40	7	6
Individual Income Taxes	40	40	6	6
Corporate Income Taxes	25	24	3	4
Other Taxes	48	48	9	9
Current Charges (User Fees)	48	43	9	9
Other Revenue	44	35	8	8

* A rank of 1 indicates the highest tax burden among the 50 states and the District of Columbia.

** A rank of 1 indicates the highest tax burden among Arizona, California, Colorado, Nevada, New Mexico, Oregon, Texas, Utah, and Washington.

*** Per \$1,000 of personal income.

Source: U.S. Department of Commerce, Census Bureau, *State and Local Government Finances*.

Table 14.3
Combined State and Local Government Tax Collections as a Percentage of Total Taxes, Western States and United States, Fiscal Year 2006

	Property Taxes	General Sales Taxes	Selective Sales Taxes	Individual Income Taxes	Corporate Income Taxes	Other Taxes
United States	30.0%	23.6%	10.9%	22.5%	4.4%	8.6%
Arizona	27.7	37.4	9.5	16.3	4.5	4.7
California	22.7	24.6	7.1	31.3	6.3	7.9
Colorado	30.6	27.9	8.2	24.7	2.7	5.7
Nevada	25.7	34.0	24.9	0.0	0.0	15.5
New Mexico	13.7	35.4	10.6	16.1	5.4	18.8
Oregon	29.7	0.0	8.7	44.7	3.9	13.0
Texas	42.9	29.8	15.3	0.0	0.0	12.1
Utah	22.7	29.2	10.8	27.5	4.2	5.7
Washington	27.5	46.9	14.3	0.0	0.0	11.3

Source: U.S. Department of Commerce, Census Bureau, *State and Local Government Finances*.

share of tax revenue. Arizona's dependence on the three major sources was second highest among the western states. In contrast, Nevada and New Mexico received relatively little revenue from these sources. Arizona's relative balance among the three major taxes—property, general sales, and income—was third highest among the western states; Colorado and Utah had more balance.

Arizona's use of selective sales taxes was a little below both the national average and the norm of the western states. The state's share of tax revenue from the corporate income tax was near the national average but above the western norm since three states did not use this tax. Arizona's use of "other" taxes was the lowest among the western states and considerably below the national average.

Between 1993 (the first year that the Census Bureau divided the corporate from individual income tax) and 2006, Arizona's relative use of the property tax fell considerably. In contrast, sales taxes accounted for an increasing share of the revenue.

The shifts in revenue sources in Arizona between 1993 and 2006 partially reflected patterns throughout the comparison states but mostly were in sharp contrast to the other western states. Arizona was the only western state to experience a decline in share from the individual income tax. Though most western states became less dependent on the property tax, Arizona's rate of decline was the second greatest. Only three western states became more dependent on the sales tax, with the shift in Arizona by far the largest.

Arizona's own-source revenue system produces unusually volatile revenues, particularly for the state government. An analysis of annual own-source state government revenue from 1992 through 2007 indicates that Arizona had the sixth-most volatile revenues among the 50 states. Two of the western states (Nevada and Utah) ranked among the top five.

Revenue Intensity Indexes and Other Measures

As an alternative to the per capita and per \$1,000 of personal income measures, revenue intensity indexes were produced for each state using the Census Bureau data for 2005.⁵ The intensity indexes compare actual collections against the capacity of each state to collect revenues as measured by the gross domestic product by state. Arizona's capacity to raise own-source revenue was 6% less than the national average, the sixth highest among the nine western states. In the tax category, Arizona ranked third among the western states, though its capacity was 3% less than the national average. Arizona's capacity on the general sales tax was far above average, second highest among the nine states. Though below average, Arizona's capacity was third highest on the corporate income tax and fourth highest on the property tax. Capacities were lower for each of the other taxes and Arizona ranked below the middle of the western states. The capacity was 36% below average for the individual income tax. In the user fees category, Arizona's capacity was the lowest among the nine states.

In the study of tax burden produced by the government of the District of Columbia (see Chapter 9), the overall tax burden in Phoenix ranked sixth or seventh highest among the nine cities in the western states at each of the four highest incomes. At the lowest income, Arizona had the highest tax burden. Arizona's sales tax burden was the highest at all income levels and the property tax burden was low.

Based on the Tax Foundation's measure of tax burden (see Chapter 9), Arizona ranked seventh among the nine western states in 2008. Nevada had a considerably lower, and Texas a marginally lower, tax burden. In 1979, Arizona had ranked fourth highest.

CASE STUDY: UTAH AND ARIZONA

Utah was selected to be compared with Arizona on a more extensive basis because it received the highest grade in *Governing* magazine's 2008 edition of "Grading the States," and because of its geographic proximity and political similarities to Arizona. *Governing* considers Utah to be a "leader in sound government based on smart planning and effective performance management."

The Pew Center on the States, which produced "Grading the States," went into more detail.⁶ Utah was lauded for addressing long-term issues, by:

- Nearly fully funding the pension system (Arizona rates average).
- Keeping up with infrastructure maintenance needs (Arizona has not).
- Carrying little debt (Arizona is better than average).
- Adjusting post-employment benefits (Arizona has not).

The executive and legislative branches in Utah both use the goals and objectives stated in the state's strategic plan (Arizona does not have a strategic plan) and share a financial system (separate revenue projections are produced in Arizona). Utah's structural balance between revenues and expenditures is good; the current cyclical budget deficit is less than the national average (Arizona is described as having a "crisis"). Further, Utah differentiates between one-time revenues/expenditures and ongoing revenues/expenditures (Arizona does not always do this). In addition, Utah has strong internal controls regarding the management of federal dollars (Arizona uses a decentralized system).

The tax burden in Arizona is lower than in Utah based on the Tax Foundation's measure. Arizona has been lower since the measure began in 1977. Using the District of Columbia's study, Arizona's tax burden at the four highest income levels was considerably lower than in Utah, but was a little higher at the lowest income level. At most income levels, Arizona had higher property, sales, and automotive taxes, but very much lower income taxes.

Economic and Demographic Context

A brief summary of Arizona and Utah is provided in Table 14.4. In order to be consistent with the latest Census Bureau government finance data, the data for other indicators also are for 2006. The size of Arizona's economy is considerably larger than that of Utah: in 2006, Arizona was 2.4 times larger based on gross domestic product by state and population, and 2.6 times larger based on personal income. Median household income was 7% lower in Utah, but because of a larger average household size in Utah, Arizona's personal income per capita was 11% more than in Utah.

Per capita state and local government revenue, overall and own-source, was lower in Arizona than in Utah. The difference was even larger per \$1,000 of personal income. Per capita taxes were marginally higher in Arizona, but the tax burden in Arizona was lower on each of the other measures. Property tax and general sales tax collections were higher in Arizona on both measures, but collections from the personal income tax and user fees were much lower.

Table 14.4
Comparison of Arizona and Utah, 2006

	Arizona	Utah	Arizona Ratio to Utah
Population	6,058,886	2,542,274	2.38
Personal Income (thousands)	\$191,600,000	\$72,705,000	2.64
Gross Domestic Product by State (millions)	\$222,456	\$92,317	2.41
Median Household Income	\$47,625	\$51,309	.93
Per Capita Personal Income	\$31,623	\$28,598	1.11
State & Local Government Revenue (thousands)	\$45,324,175	\$20,781,428	2.17

Combined State and Local Government	Per Capita		Per \$1,000 of Personal Income		Arizona Ratio to Utah	
	Arizona	Utah	Arizona	Utah	Per Capita	Personal Income
General Revenue	\$6,021	\$6,605	\$190.41	\$230.97	91.2%	82.4%
Own Source	4,566	5,222	144.39	182.59	87.4	79.1
Taxes	3,291	3,258	104.07	113.93	101.0	91.3
Property	912	738	28.83	25.81	123.6	111.7
General Sales	1,232	952	38.95	33.29	129.4	117.0
Individual Income	537	896	16.98	31.32	59.9	54.2
Corporate Income	147	137	4.65	4.79	107.3	97.1
Other Taxes	463	535	14.66	18.72	86.5	78.3
Current Charges	729	1,364	23.06	47.68	53.4	48.4
Other Revenues	546	600	17.26	20.98	91.0	82.3

Source: U.S. Department of Commerce, Census Bureau and Bureau of Economic Analysis.

Study Comparing Utah to Other States

A recent study evaluated and compared Utah's tax system, specifically state income taxes, sales taxes, and property taxes, to other western states: Arizona, Colorado, Idaho, Montana, New Mexico, Nevada and Wyoming.⁷ Utah recently underwent major changes to its tax policy by enacting a single-rate income tax (reducing taxes in the process) and reducing the sales tax rate on food to be consumed at home. The authors of the study state that the tax reforms passed by the Utah Legislature in 2006 and 2007 have improved Utah's income and sales taxes relative to guiding principles.

The single-rate income tax that went in effect in 2008 was rated among the best in the eight states with respect to the principles of simplicity, neutrality, stability, sufficiency, and balance. As discussed below, effectively it is not a flat tax, so it does not compare poorly on horizontal equity (regressivity). Arizona's income tax system was viewed as more competitive due to its lesser tax burden. The sales tax in Utah was simplified by establishing a single statewide rate on food for home consumption. The property tax is considered transparent, and the sales and property taxes perform well in terms of neutrality.

Sources of Revenue

The composition of revenue sources in 2006 was considerably different in Arizona than in Utah. As a proportion of total own-source revenues, user fees made up a much lesser share, and thus tax collections represented a larger share, in Arizona (see Table 14.5). Within the tax category, substantial differences also were present. Arizona derived a lesser share from the individual income tax but larger shares from the sales and property taxes. Utah achieved a much greater balance than Arizona among the three major taxes.

Comparison of Utah and Arizona on the Major Sources of Taxes

Individual Income Tax

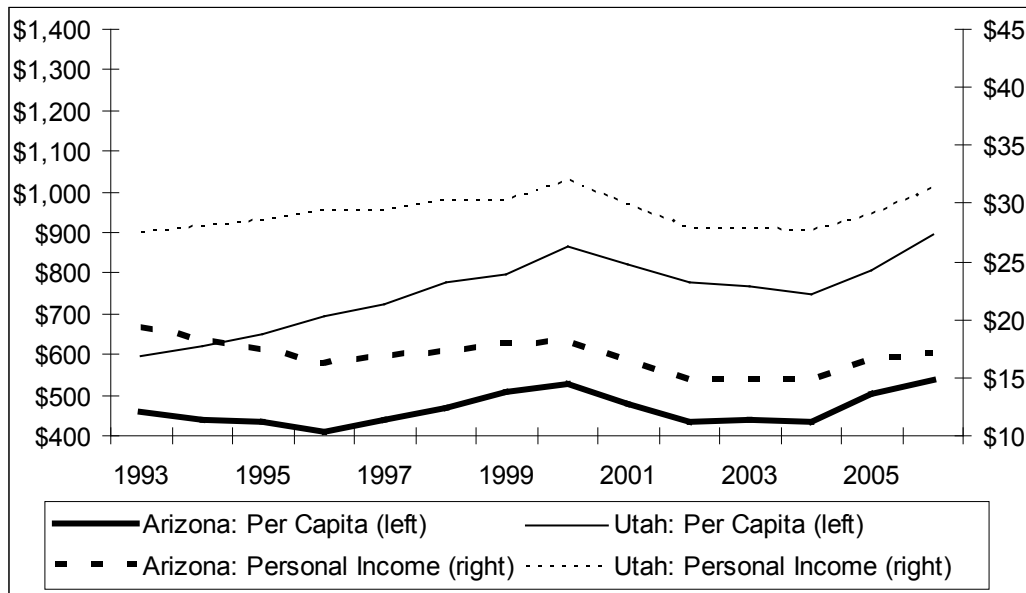
Income tax collections in Arizona and Utah are displayed in Figure 14.1 based on the per capita and per \$1,000 of personal income measures. The individual income tax burden in

Table 14.5
Shares by Source of Combined State and Local Government Own-Source Revenue, Arizona and Utah, Fiscal Year 2006

Tax Category	Arizona	Utah	Difference
Total Taxes	72.1%	62.4%	9.7
Property Tax	20.0	14.1	5.9
General Sales Tax	27.0	18.2	8.8
Selective Sales Taxes	6.8	6.7	0.1
Individual Income Tax	11.8	17.2	-5.4
Corporate Income Tax	3.2	2.6	0.6
Other Taxes	3.3	3.5	-0.2
Current Charges	16.0	26.1	-10.1
Other Revenues	12.0	11.5	0.5

Source: U.S. Department of Commerce, Census Bureau, *State and Local Government Finances*.

Figure 14.1
Individual Income Tax Collections Per Capita and Per \$1,000 of
Personal Income, Arizona and Utah, Fiscal Years 1993 Through 2006



Note: the per capita measures are expressed in inflation adjusted dollars, using the GDP implicit price deflator.

Source: U.S. Department of Commerce, Census Bureau and Bureau of Economic Analysis.

Utah has been consistently higher than in Arizona based on both measures. Arizona's individual income tax burden fell between 1993 and 2006 after considering the real per capita income growth that occurred over the period, while the tax burden rose somewhat in Utah.

However, since fiscal year 2007 (the last year in Figure 14.1), Utah has made a substantial change to its individual income tax, collecting less income tax since then. Prior to tax year 2007 (taxes due by April 2008 and collected in fiscal year 2008), Utah had a traditional graduated-rate system. In tax year 2007, taxpayers paid the lesser of the tax due by the traditional system or the tax due based on a "flat tax" calculation. Effective with the 2008 tax year (returns filed by April 15, 2009), Utah implemented a "single-rate" individual income tax. This single-rate system is not the same as the flat tax offered in the prior year. Effectively, the tax rate is graduated rather than flat. Tax filers can claim their federal deduction and 75% of their federal personal exemptions as part of a "taxpayer credit" calculation. Retirees also can claim a "retirement credit." The size of each tax credit varies proportionally with income.

As seen in Table 14.6, Arizona uses a graduated personal income tax, with a top rate less than Utah's single rate of 5%. Arizona's individual income tax system is more complex, having many more additions and subtractions, as well as a larger number of credits. Utah's system is closely tied to the federal system, based on the federal deductions and exemptions.

Table 14.6
Comparison of Individual Income Tax, Arizona and Utah, 2008

	Arizona	Utah
Range of Rate: Bottom to Top Bracket	2.59–4.54%	5% single rate
Top Bracket (married couple filing a joint return)	\$300,001	None
Number of Additions	20	8
Number of Subtractions	28	3
Number of Credits	28	21
Standard Deduction (married couple filing a joint return)	\$9,042	Federal (\$10,900)
Personal Exemptions (married couple filing a joint return)	\$4,200	75% of Federal (\$5,250)

Source: Tax codes of each state.

A comparison of the individual income tax in Utah and Arizona for tax year 2008 was made for a typical family of four at various incomes. Arizona's tax burden is much less than in Utah at all income levels except the lowest ones (less than an adjusted gross income of \$20,000), at which each state levies no tax.

Sales Tax

General sales tax collections in Arizona and Utah are shown in Figure 14.2. On both measures, the tax burden has been higher in Arizona, with the differential widening since 1999. While the per capita measure indicates that taxes paid have increased over time in both states, once real per capita gains in income are considered, the tax burden is shown to have been largely steady, falling somewhat in Utah since 1999. The most recent decline in the chart is due to Utah's lowering its sales tax on food to be consumed at home. The state rate decreased from 4.75% in 2006 to 2.75% in 2007 to 1.75% in 2008. The local rate is now standardized to be 1% for municipalities and 0.25% for counties (a total rate on food of 3%).

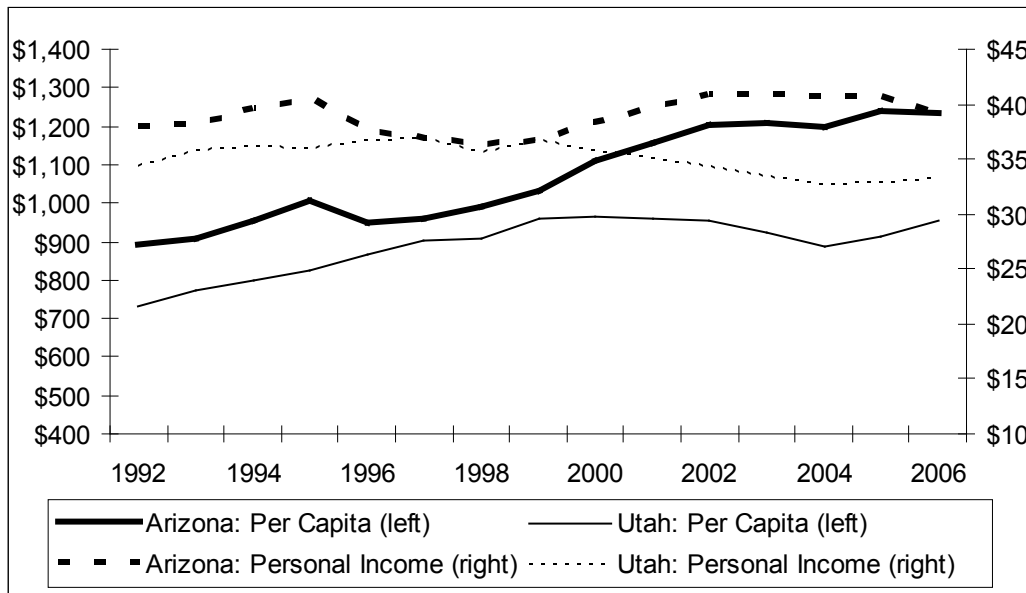
Arizona does not tax food to be consumed at home at a state level, though some local governments do tax these food items. Otherwise, Arizona's sales tax rates are higher than those in Utah at the state and municipal levels (see Table 14.7). Arizona derives a significantly larger percentage of tax revenue from sales taxes than does Utah.

Property Tax

Property tax collections in the two states are depicted in Figure 14.3. Arizona's tax burden has been higher, but the differential between the two states shrank during the 1990s. The per capita tax burden in Arizona has been flat, while the tax burden per \$1,000 of personal income has fallen.

It is difficult to compare property taxes from one state to another due to very different methods of calculating taxes and because multiple jurisdictions levy property taxes. Thus, the property tax due on an identical property varies across each of the states. Overall, property taxes have accounted for a larger share of state and local government revenues in Arizona than in Utah.

Figure 14.2
General Sales Tax Collections, Arizona and Utah,
Fiscal Years 1992 Through 2006



Note: the per capita measures are expressed in inflation adjusted dollars, using the GDP implicit price deflator.

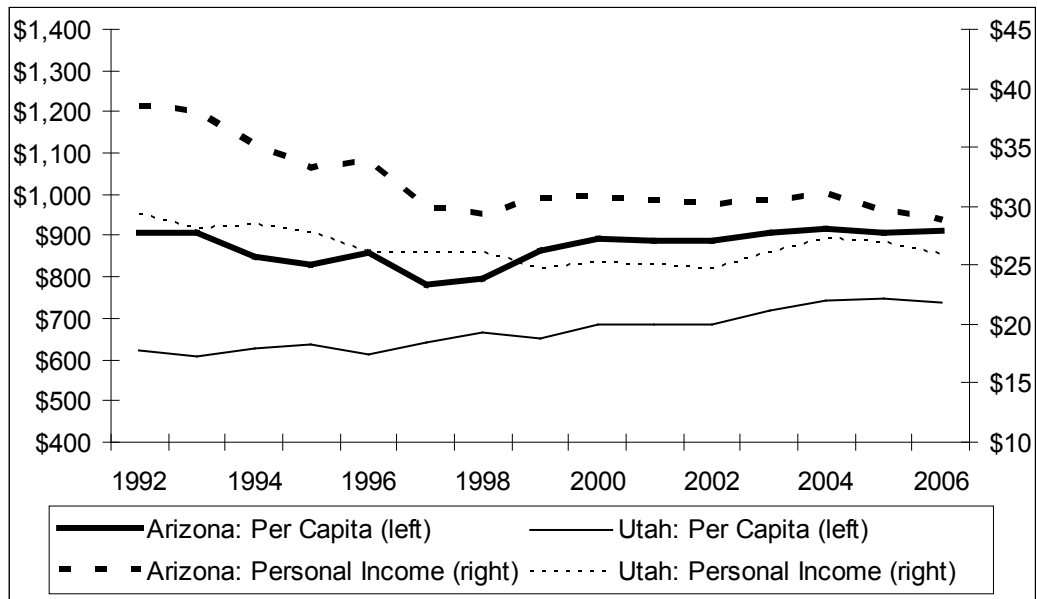
Source: U.S. Department of Commerce, Census Bureau and Bureau of Economic Analysis.

Table 14.7
Comparison of Sales Tax, Arizona and Utah

	Arizona	Utah
State Rate	5.6%	4.75% in 2006 and 2007, 4.65% in 2008, 4.7% in 2009
Municipal Rates	1.5–4%	1–2.9%
County Rates	0.25–1.125%	0.25–1.25%
Maximum Total Rate in 2009	10.725%	8.35%
Food to be Consumed at Home	Exempt at state level	State rate of 4.75% in 2006, 2.75% in 2007, 1.75% in 2008 and 2009
Services	58 services taxed	57 services taxed

Source: Tax codes of each state.

Figure 14.3
Property Tax Collections, Arizona and Utah,
Fiscal Years 1992 Through 2006



Source: U.S. Department of Commerce, Census Bureau and Bureau of Economic Analysis.

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¹ Katherine Barrett et al., "The Way We Tax: A 50-State Report," *Governing* (February 2003), <http://www.governing.com/gpp/2003/gp3intro.htm>.

² Katherine Barrett and Richard Greene, "The Mandate to Measure," *Governing* (2008), <http://www.governing.com/gpp/2008/index.htm>. This article was based on a study produced by the Pew Center on the States: *Grading the States 2008*, http://www.pewcenteronthestates.org/gpp_report_card.aspx.

³ Iris J. Lav and Elizabeth McNichol, *State Budget Troubles Worsen* (Center on Budget and Policy Priorities, June 29, 2009), <http://www.cbpp.org/cms/index.cfm?fa=view&id=711>.

⁴ U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

⁵ L. William Seidman Research Institute, Arizona State University, *Tax Revenue Intensity Indexes: Fiscal Trends to Watch* (February 2008). This report was produced for the Pew Center on the States.

⁶ Pew Center on the States, http://www.pewcenteronthestates.org/gpp_report_card.aspx.

⁷ Janice Dubno and Levi Pace, *An Evaluation of Utah's Tax System and a Comparison of Eight Intermountain Western States* (Center for Public Policy and Administration, University of Utah, November 2007).

Chapter 15

ANALYSIS OF ARIZONA'S REVENUE SYSTEM BY SOURCE OF FUNDING

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KEY POINTS

- User fees are relatively lightly used in Arizona.
- Per capita, Arizona receives a below-average amount of federal funds, including large shortfalls from the U.S. Department of Transportation.
- Arizona governments, especially the state's general fund, are unusually dependent on the general sales tax. The sales tax has a high combined state and local government tax rate, many exemptions, and a narrow base.
- Property taxes in Arizona are quite low for homeowners but are moderate to high for businesses.
- Similarly, the personal income tax burden is low, but corporate income taxes are moderate. Numerous tax credits are offered for each.
- Selective sales taxes, including some for alcoholic beverages, are relatively lightly used in Arizona.
- Little use is made of various other tax sources in Arizona.

INTRODUCTION

This chapter incorporates information from the preceding chapters of this report and adds detail for each of the larger sources of public-sector revenue in Arizona. In particular, empirical data on state and local government revenues (Chapter 9), revenue system guiding principles (Chapter 11), and recommendations of the Citizens Finance Review Commission (Chapter 12) are included.

While this chapter separately analyzes each revenue source, experts recommend that revenues be considered as part of a system and that any revenue reform be considered from a comprehensive rather than piecemeal perspective. All references to years in this chapter apply to the state's July 1–June 30 fiscal year.

NONTAX REVENUE

User Fees

State government charges fees for industries it regulates and for some of the services it provides. Conceptually, fees 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.

User fees are most efficient when the cost of the charge provides sufficient revenue to support the delivery of a quality service. Inefficiencies can arise when governmental 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 fee structures that are fixed through time with no allowance for inflation or other pressures on the cost of service delivery.

The Arizona Joint Legislative Budget Committee (JLBC) reported that the category of “licenses, fees, and permits” accounted for only 2% of the state general fund revenue in 2009.¹ However, using 2006 data from the U.S. Census Bureau, whose accounting system incorporates other funds than just the general fund, user fees (the Census Bureau calls these “current charges”) accounted for 6% of state government revenues.² Fees contributed nearly 14% of local government revenue.

As defined by the Census Bureau, per capita state government user fees in Arizona in 2006 were only half the national average, and the local government figure was 25% less than average. The shortfall was \$228 per person at the state level and \$169 per person among local governments. If the per capita dollar figures had equaled the national averages, Arizona’s revenue from user fees would have been \$1.4 billion higher for state government and \$1.0 billion higher for local governments.

State government collections of user fees for higher education—the largest category nationally, consisting largely of tuition—were 21% less than the national per capita average in Arizona, but the local government figure was 47% higher than average. The combined figure was 14% less (\$39 per person) than average. If the combined per capita dollar figure had equaled the national average, Arizona’s user fees from higher education would have been \$236 million higher.

Arizona’s low overall collection of user fees relative to the U.S. average is in part explained by the relatively small number of public hospitals in the state. User fees for public hospitals on a per capita basis at the combined state and local government level in Arizona were 70% below the national average in 2006. If the combined per capita figure had equaled the national average, collections would have been \$1.2 billion higher.

Other than the hospital and higher education categories, Arizona governments collected \$1 billion less in user fees than if the per capita figure had equaled the national average. This shortfall occurred across a number of categories, including highways.

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.”³ 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. As the economy and requirements for economic development have evolved, certain state and local government services have increased in importance. 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. The transportation network and other components of the physical infrastructure also are of key importance. 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. Similarly, additional investment in higher education may require higher tuition assessments.

Federal Funds

Federal funds are a significant source of state and local government funding. In 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 was below the per capita average.

In 2007, federal grants to Arizona governments on a per capita basis were 10% less than the national average.⁴ 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% of the grants nationally. Arizona’s per person figure from the U.S. Department of Education, which was responsible for 7% 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% below average from the U.S. Department of Housing and Urban Development (HUD), from the U.S. Department of Transportation (DOT), and from the balance of the federal funding sources. Arizona’s shortfall amounted to \$541 million from DOT, \$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.

Other Nontax Revenue

The Census Bureau identifies four other categories of nontax government revenues:

- Interest earned. In 2006, Arizona's per capita figure was 37% below average in state government, but the local government figure was nearly equal to the national average for local governments. 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 2006.
- Sale of property. The 2006 per capita revenue for state government was far higher than average while the local government figure was a little below average.
- Miscellaneous. In 2006, Arizona's per capita figure was 39% below average in state government and 16% 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, as discussed in Chapter 12.

TAX REVENUE

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.

General Sales Tax

Arizona's transaction privilege tax—commonly referred to as the general sales tax—is part of the broader JLBC category of "sales and use" taxes.⁵ General fund revenue from the sales and use tax totaled nearly \$3.8 billion in 2009. This figure does not include revenue from the 0.6% of the sales tax that is earmarked for education, nor does it include the monies distributed to local governments. Use taxes apply to goods purchased in states without a sales tax and to several specialized categories, such as a mining severance tax.

The general sales tax is applied to 16 categories; a 5.6% tax is levied in most. In 2008, the retail category accounted for 46% of the revenue and the restaurant and bar category contributed 8%. The other major category was contracting, which generated 22% of the revenue. The revenue from the state tax is shared with counties and municipalities through a complex system of formulas.

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% is exactly in the middle of the 45 states that apply a general sales tax. Arizona's tax rate also is at the median of the nine western states. However, county and municipal sales taxes push the overall sales tax rate to more than 10% in some Arizona communities.

Despite the increases in the overall tax rate, several legislative changes over the past 15 years have lowered collections from the general sales tax. 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.

The general sales tax is a regressive tax: lower-income people pay higher shares of their income in sales tax than do higher-income consumers. Arizona is among the 31 of 45 states that applies a general sales tax but excludes food intended for consumption at home from taxation as a means of reducing regressivity. 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.

As in most states, 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.

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 2006 were 15% (\$112) higher than the national average, according to the Census Bureau data. Per capita local government collections were 83% (\$154) higher than the national average, demonstrating Arizona's above-average use of the sales tax by local governments. 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 heavy dependence on the sales tax in Arizona is verified by the government of the District of Columbia study discussed in Chapter 9.⁶ Using 2007 data, the sales tax burden in Phoenix was second highest among the 51 cities at four of the five income levels, and highest in the other.

Given these high sales tax burdens and Arizona's collections from income and property taxes being substantially below average, the state is unusually dependent on sales and use taxes. According to the JLBC, 54% of the general fund revenue in 2009 came from the sales and

use tax. Using the broader Census Bureau accounting, the dominance is not as high, but 23% of all state government revenue came from the general sales tax in 2006.

In addition to high tax rates and a narrow base, sales tax exemptions are a concern in Arizona. Many sales tax exemptions have been passed since 1980. According to the Morrison Institute for 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 in 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 Arizona Department of Revenue estimated that \$9.7 billion in additional revenue could have been raised in 2008 at a 5% tax rate if all exemptions were ended.⁷ 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, even at tax rates less than 5%.

As currently structured, Arizona’s general sales tax compares poorly against the revenue system guiding principles adopted by the CFRC, as discussed in Chapter 11. 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 the guiding principles. Several of the CFRC’s recommendations addressed these issues (see Chapter 12).

Property Tax

The property tax is a tax on the market value of privately owned property. Real property includes land, buildings, and other improvements to the land, such as mobile/manufactured homes that are permanently affixed to land that is owned by the owner of the mobile home. Personal property used for commercial purposes, such as equipment and machinery, also is taxed. 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.

Property taxes across the nation largely are levied by local governments. Arizona levied a statewide tax through 1996. Property tax revenue to the general fund fell \$150 million in the following year when the tax was repealed.

Using the Census Bureau’s accounting system, a greater amount of property tax is shown as general revenue to state government, but the property tax still accounted for less than 2% of

the total in 2006. The per capita state government figure was higher than the national average, but the difference amounted to only \$25 per person.

In contrast, though property taxes accounted for close to one-fourth of local government revenue, this share was less than the national average. Local government per capita property taxes in Arizona were considerably less than the national average in 2006. Per capita property tax collections of state and local governments combined were 25% (\$306) less than the U.S. average 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 in tax burden between residential and business properties. Business property taxes are quite high relative to residential property taxes. Several legislative measures, currently being phased in, are reducing the property taxes on businesses. Still, once the changes are phased in, the assessment ratio on most commercial and industrial owners in the state will be 20%—twice as high as the residential property tax ratio. (The assessed value of a property is multiplied by the assessment ratio. The resulting net assessed valuation is multiplied by the tax rate to determine the tax liability.)

Residential property owners in Arizona enjoy very low residential property tax burdens. The tax in Phoenix was about 37% below the average city in the District of Columbia tax study in 2007. Phoenix ranked 42nd or 43rd among the 51 cities at each income level.

The Tax Foundation in September 2008 released a ranking by county of residential property taxes in 2007.⁸ 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. Maricopa County's ranks were 500th, 691st, and 575th respectively.

Relative to the revenue system 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 assessment ratios by category of property, and the system is highly complex, due to 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.

Several of the CFRC recommendations were related to the property tax. The commission suggested re-enacting the option of a state property tax, applied on a uniform assessment ratio (the assessment ratio for residential, commercial, and other property categories would be the same); eliminating the 1-percent constitutional cap on residential property tax; phasing out the homeowner's rebate; reducing overall business property tax burdens, particularly the

business personal property tax on locally assessed business personal property; and applying a uniform assessment ratio on all future voter-approved property tax-funded bonds and overrides. In addition, the CFRC recommended using property taxes to fund school construction.

Personal Income Tax

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 personal 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 District of Columbia study using 2007 tax rates, nine states do not levy an income tax on wages. Among the remaining states and District of Columbia, 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 2006, the per capita personal income tax collection of state and local governments in Arizona was 41% below the national average, with state government 36% below average. If the combined per capita dollar figure had equaled the national average, Arizona's collections would have been \$2.3 billion higher. The individual income tax provided only 14% of state government general revenue in 2006; the share was only 9% for state and local governments combined.

Using the JLBC's definition of the general fund, personal income tax revenue of \$2.6 billion accounted for 37% of total revenue in 2009. However, this overstates the impact, since a portion of income tax collections are shared with cities and towns ("urban revenue sharing"). The net revenue from the individual and corporate income tax combined less revenue sharing was \$2.4 billion (35% of the total general fund revenues).

Always a volatile source of revenue, income tax revenue in recent years has varied even more widely due to the volatility of capital gains. 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 for 2007 show only a small decline, but the decrease certainly was much larger in 2008. As a percentage of personal income, capital gains went from nearly 7% in 1999 to 2.5% in 2002 to 8% in 2005. With the real estate bust and the weakness in the stock market, current shares certainly are much lower.

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 income tax increases passed in 1989 and 1990. Rates currently are about 35% lower than in 1990. The

first large tax cut was passed in 1994; 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 since the early 1990s.

The personal income tax currently compares more favorably against the guiding principles than the general sales and property taxes, but less opportunity exists for improvement. Reducing the number of tax credits would improve the neutrality of the personal income tax. Tax brackets could be indexed for inflation.

Corporate Income Tax

Many states apply a flat tax rate to corporate income. In most states that apply the corporate income tax progressively by using multiple tax rates and brackets, the top tax rate is applied at a relatively low income level.⁹ This makes comparing Arizona's 6.968 percent rate more straightforward than comparing personal income tax rates across the states. Compared to the top tax rate by state, Arizona's corporate rate is at the median of all states. However, among the nine western states, only California and New Mexico have a higher top tax rate, and New Mexico's higher rate does not apply until taxable income tops \$1 million.

According to the JLBC, the corporate income tax accounted for 8.5% of general fund revenue in 2009, but this is before the deduction for urban revenue sharing is considered. Collections from the corporate income tax are highly volatile from year to year. According to the Census Bureau, the corporate income tax was responsible for 4 percent of state government tax revenue in Arizona in 2006, slightly above the national average. The corporate income tax accounted for only 2 percent of all state and local government revenue in Arizona in fiscal year 2006, the same share as the national average.

The corporate income tax burden in Arizona is average when compared to all states, but high relative to the comparison states. The corporate income tax generally does not compare favorably to the guiding principles, receiving the second worst overall evaluation among the larger tax sources. In addition to its cyclical nature, the tax has many credits and the tax code is complex. The tax code is outdated in that it was written largely with manufacturers in mind and does not handle the growing interstate and international activity well.

Income Tax Credits

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

Until 1981, no corporate income tax credits existed. 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 Arizona Department of Revenue indicates that the general fund did not realize at least \$103 million in claimed corporate tax credits in tax year 2006.

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 personal credits removed \$282 million from the general fund, according to 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. In tax year 2007, \$93 million was claimed from the public and private school tax credits alone.

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

The private school tuition tax credit has recently been criticized by the *Arizona Republic* and the *East Valley Tribune* as not achieving its stated goals.¹⁰ A legal challenge to the constitutionality of this credit also is pending.

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 pari-mutuel 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 tax accounted for 5.9% of ongoing general fund revenue in 2009, up from 4.7% the year before. Unlike virtually all other revenue sources, collections from the insurance premium tax did not fall in 2009. Luxury taxes (liquor and tobacco) contributed less than 1% of state government general fund revenues in 2009. Proceeds from the motor fuels tax do not go into the general fund; most of the revenue is placed in the highway user revenue fund.

Using the broader Census Bureau accounting (which classifies the motor fuels tax collections as general revenue), selective sales taxes accounted for 7% of state government revenue in 2006, but only 1% of local government revenue. As a whole, per capita collections of selective sales taxes were 28% less than the national average for state governments and 36% 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 typically 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, tied for 38th highest among the states. However, the per capita collection in 2006 was at the national average. A number of factors could account for average per capita collections despite a lower-than-average rate: 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 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.

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 across states, from just 7 cents to \$2.57 per 20-cigarette pack. In a few states, counties and cities may impose an additional tax. Arizona’s \$2 cigarette tax is tied for fourth highest, but per capita collections of the tobacco tax in 2006 were marginally less than the national average. The tax rate is not indexed to inflation. Other tobacco products such as cigars and snuff also are taxed, but the tax rate is calculated by differing means across the states.

The tobacco tax has a mediocre rating relative to the guiding principles, in part due to its regressive nature. In addition, declining sales of tobacco products over time translate into declining government revenue from this source.

Alcoholic Beverages

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 ranks 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 2008, but less than \$29 million went into the general fund. The corrections fund received \$24 million while the remainder was placed into various other funds. The alcoholic beverage license tax added \$6 million, with \$5 million going to the general fund and the remainder to various other funds.

Using Census Bureau data, state and local government collections from alcohol taxes in Arizona were 45% less than the national average on a per capita basis in 2006. 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 guiding principles. Indexing of the tax rates to inflation would improve responsiveness.

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 public utilities tax compares favorably to the guiding principles.

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 2006, Arizona makes little use of this tax. The per capita collection of state and local governments was 62% below the national average, with state government 92% below average and local governments 35% below average. If the combined per capita dollar figure had equaled the national average, Arizona’s collections would have been \$305 million higher.

Other Selective Sales Taxes

Other selective sales taxes include the amusements and pari-mutuels 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.

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%. The JLBC reports revenue of \$438 million in 2008, with \$407 million being placed in the general fund. The remainder was transferred to local governments and to the public safety retirement system.

Based on the Census Bureau data, per capita collections of all other selective sales taxes by state and local governments in Arizona was 44% below the national average in 2006, with state government 49% below average and local governments 23% 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.

Vehicle License Tax

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. Relative to the guiding principles, the vehicle license tax compares quite favorably except in terms of its exportability, since it applies only to residents.

The Legislature reduced the state portion of the vehicle license tax in 1998 and ended the deposit to the general fund in the following year. According to the JLBC, state government revenue from this tax fell from more than \$160 million in 1998 to zero in 2002.

According to Census Bureau accounting, the portion of the vehicle license tax that is based on value is classified as a property tax. The Census Bureau's vehicle license tax category is limited to fees for licenses, title registration, license plates, vehicle inspection, and the like. Using this definition, per capita collections of state and local governments in Arizona were 55% below average in 2006. Approximately \$231 million more would have been collected if per capita collections had equaled the national average. However, the Census Bureau may be missing some of the fees collected in Arizona.

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 automotive category; data for the individual components are not available. Overall, automotive-related taxes in Phoenix were near the national median in 2007 in the two lowest income levels, but above the norm at the other three incomes.

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 the miscellaneous tax category were 80% less than the national average in 2006. Local government collections were 12% 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.

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¹ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm>.

² U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

³ Citizens Finance Review Commission, *A Fiscal Tool Box* (January 2004), 10, <http://www.azcfr.com> under "Documents & Resources."

⁴ U.S. Department of Commerce, Census Bureau, *Consolidated Federal Funds Report*, <http://www.census.gov/govs/www/cffr.html>.

⁵ Each of the state government's tax revenue sources is discussed in the *Tax Handbook* produced annually by the Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc/08taxbook/08taxbk.pdf>.

⁶ Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia: A Nationwide Comparison, 2007* (August 2008), <http://cfo.dc.gov/cfo/cwp/view,a,1324,q,612643.asp>.

⁷ Arizona Department of Revenue, *The Revenue Impact of Arizona's Tax Expenditures FY 2007/08* (November 17, 2008, preliminary), <http://www.revenue.state.az.us/ResearchStats/Taxep08P.pdf>.

⁸ Tax Foundation, <http://www.taxfoundation.org/taxdata/show/1888.html>.

⁹ Federation of Tax Administrators, http://www.taxadmin.org/fta/rate/corp_inc.html.

¹⁰ See the *Arizona Republic* on August 1, 2009, <http://www.azcentral.com>, and the *East Valley Tribune* on August 18 and 19, 2009, <http://www.eastvalleytribune.com>.

Chapter 16

TWO ALTERNATIVES TO IMPROVE THE MANAGEMENT OF THE STATE GOVERNMENT GENERAL FUND

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KEY POINTS

- Historically, Arizona state government general fund revenues typically equaled 4.5% of the state's gross domestic product, but this share has declined substantially since 1995.
- Revenues also have fallen relative to personal income and to adjusted gross income reported by taxpayers.
- The relative decline in revenues primarily has resulted from the substantial tax reductions implemented since the mid-1990s.
- Actual revenues have not attained the trend line based on economic growth since 1995, causing a structural budget deficit. The structural deficit will continue to grow without changes to revenues and/or expenditures.
- Revenues are currently highly cyclical and are not growing at the pace of the economy. A modernized tax code that employs a broad tax base, supplemented by expanded nontax sources of revenue and improved planning and money management, will result in much more stable revenues over the economic cycle and long-term growth equal to economic gains.
- Additional improvement in the functioning of the general fund could be achieved by targeting revenue to a fixed share of the economy and by tying spending increases to the sum of population growth, inflation, and real per capita economic growth.
- Alternatively, the budget stabilization fund could be strengthened so that it has a larger balance to offset cyclical declines in revenue.

INTRODUCTION

Whereas Chapter 15 presents information on individual revenue sources, which might be useful if comprehensive revenue reform is undertaken, this chapter addresses the broader issue of trying to ensure that the general fund will have enough money to fund the spending needs of the state even during recessionary periods.

The primary alternative explored in this chapter focuses on the revenue system guiding principles of stability, responsiveness, and predictability (see Chapter 11). It is intended to demonstrate that a significantly less cyclical revenue system can be designed. In the second alternative, the revenue system is not changed, but the budget stabilization fund is strengthened and additional contingency funds are used so that the monies available to the general fund would result in more stable expenditures than has been experienced during the last decade.

An Examination of General Fund Revenues

To control for inflation, population growth, and real per capita economic gains, revenues have been presented per \$1,000 of personal income throughout this report. In this chapter, revenues also are presented relative to gross domestic product (GDP) for the state and to aggregate adjusted gross income (AGI) of Arizona residents (plus the Arizona share of nonresident incomes).¹ Adjusted gross income—the top line on the Arizona tax return—presents an alternative that is particularly appropriate for the determination of tax burdens. Unlike personal income, adjusted gross income includes capital gains income. Since GDP is the broadest measure of the size of an economy, it is the measure used in the first alternative to the existing method of budgeting government revenues.

For each measure, fiscal year revenue is compared to the prior calendar year's economic activity. This is necessary since the GDP and AGI measures are available only annually based on the calendar year. To be consistent with these two measures, calendar year personal income also is used, making the figures per \$1,000 of personal income different from those presented in Chapter 7, which is based on fiscal year personal income. The most recent actual GDP and personal income data are for calendar year 2008. The latest tax data are for 2007. The revenue data run through fiscal year 2009. Revenue has been projected through fiscal year 2011 while the economic measures have been projected through calendar year 2010.

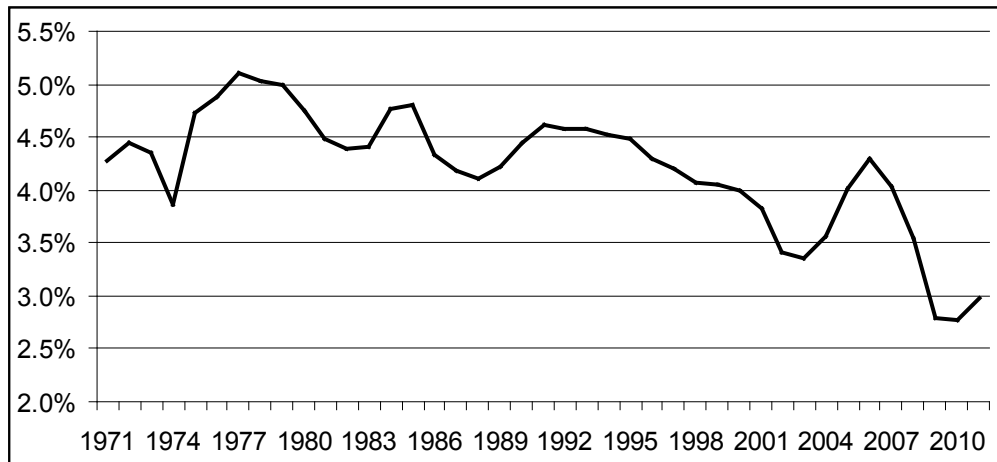
A simple comparison of Arizona state government general fund revenue, as reported by the Arizona Joint Legislative Budget Committee (JLBC),² to the size of the Arizona economy reveals that revenue is decreasing as a percentage of the overall economy. Figure 16.1 displays state government general fund ongoing revenue as a proportion of the state's gross domestic product. Ongoing revenue excludes any carry-forward amount from the prior year and any transfers from other funds to the general fund. In Figure 16.2, ongoing revenue is shown per \$1,000 of personal income and per \$1,000 of adjusted gross income.

A very large decline in revenue since the mid-1990s is obvious relative to each of the three economic measures, though considerable cyclicalities is present. Generally, revenue relative to each of the three measures declines during economic slowdowns and rises during expansions.

From fiscal years 1975 through 1995, state general fund ongoing revenue fluctuated around 4.5% of Arizona GDP for the prior calendar year. After gradually declining through the 1990s economic expansion, the share fell below 3.5% during and after the last economic downturn (fiscal years 2002 and 2003). After recovering to more than 4% (but not reaching the historical norm of 4.5%) during the last economic boom, revenues dropped significantly from fiscal years 2007 through 2009, dropping to an all-time low of less than 3% of GDP.

Expressed per \$1,000 of personal income in the prior calendar year, revenue averaged \$52.50 from fiscal years 1971 through 1995 but fell to less than \$40 in 2003. The peak in the next expansion was less than \$51 in 2006, then the figure slid to less than \$33 in 2009. Similarly, revenue per \$1,000 of AGI averaged \$80 from 1984—the first year of data—through 1995 but dropped to less than \$60 in 2002. After a modest recovery to \$68, revenue per \$1,000 of AGI fell to below \$49 in 2009. These measures of revenue decline are consistent with the tax burden data generated by the Tax Foundation and discussed in Chapter 9.³

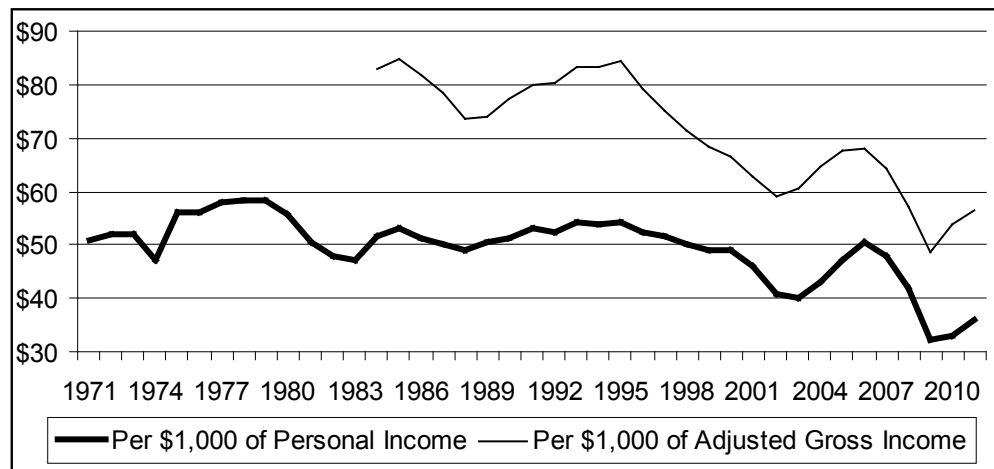
Figure 16.1
State Government General Fund Ongoing Revenue as a Share of State Gross Domestic Product, Arizona, 1971 Through 2011*



* Fiscal year 2010 and 2011 revenues are projected, as is GDP for calendar years 2009 and 2010.

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

Figure 16.2
State Government General Fund Ongoing Revenue Relative to Personal Income and Adjusted Gross Income, Arizona, 1971 Through 2011*



* Fiscal year 2010 and 2011 revenues are projected, as are personal income for calendar years 2009 and 2010 and adjusted gross income for calendar years 2008 through 2010.

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).

The most important factor contributing to the decline in state general fund revenue relative to the size of the Arizona economy is the 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 has accumulated to more than \$2.5 billion per year after adjusting for inflation and population growth (more than 1% of GDP). The tax cuts, coupled with revenue declines resulting from the severe recession of the last two years, have resulted in a general fund revenue base that currently is at historic lows—far below the previous lows—as a share of the Arizona economy.

Some argue that spending outside the general fund for obligations historically associated with the state general fund have allowed general fund revenue ratios to decline. The primary example is the revenue from the 0.6% increase in the general sales tax that was passed by voters in 2000 to earmark funds for education, referred to as “proposition 301.” However, this explanation ignores statutory acts that eroded 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 since the mid-1990s are examples. Voter mandated yet unfunded changes in eligibility for the Arizona Health Care Cost Containment System (AHCCCS) placed additional pressure on dwindling general fund resources. These actions more than offset the 0.6% sales tax that funds proposition 301.

Simulated Revenues

Actual general fund revenues are compared to what they would have been had they increased at the rate of the economy in Figure 16.3. The figures are not adjusted for inflation or population growth. The bars represent actual general fund ongoing revenues from 1985 through 2009, with projections thereafter. The line in the chart represents a simulated revenue trajectory based on revenue growing at the same rate as the overall economy as measured by the growth of nominal GDP. The choice of 1985 to begin the chart is arbitrary, but going back this far presents actual and simulated revenue through the two prior recessions as well as the current recession.

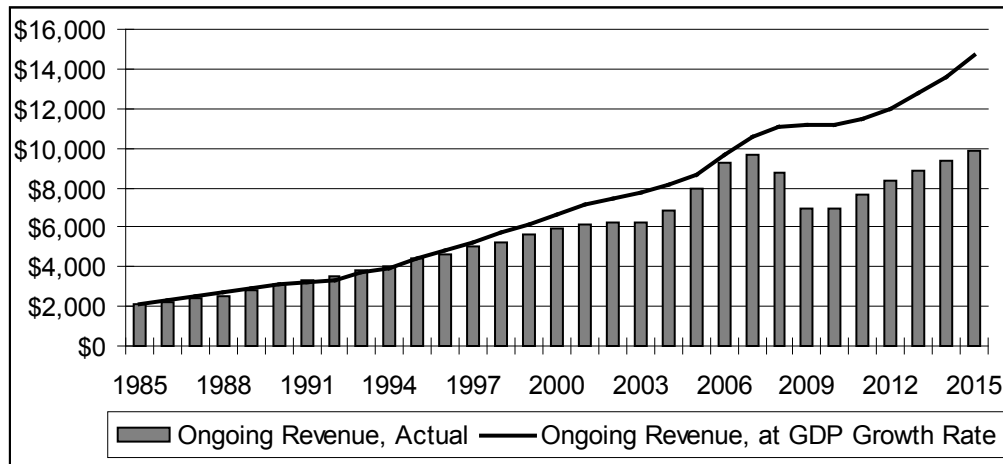
After 1995, revenue growth began to lag growth in GDP. Since 1995, in no year has actual revenue attained the trend line based on revenue growing at the pace of GDP.

In Figure 16.4, actual general fund expenditures through 2009 and projections through 2015 minus the ongoing revenue had it grown at the same pace as GDP (the line in Figure 16.3) is displayed. The graph reveals that actual expenditures exceeded simulated revenue only in the early 1990s. The gap between actual expenditures and simulated revenue grows rapidly following 1995. This chart displays the budget deficits introduced by the tax cuts, modified by the economic cycle (the deficits are especially large from 2002 through 2004 and relatively small from 2006 to 2007 due to the economic cycle). The chart is based on the assumption that spending grows with the pace of nominal GDP from 2010 through 2015.

IMPROVING THE MANAGEMENT OF THE STATE GENERAL FUND

Two alternatives for better managing the general fund, with a particular focus on reducing the magnitude of budget surpluses and deficits across the economic cycle, are discussed in

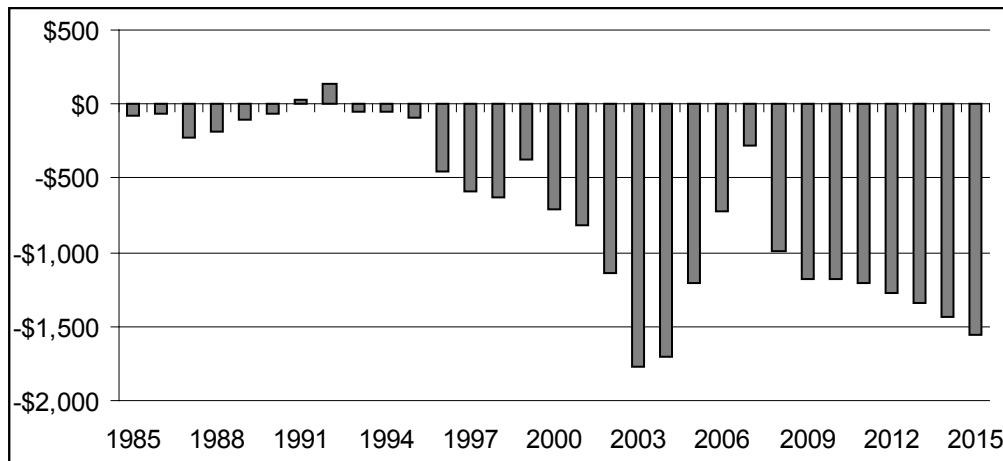
Figure 16.3
Actual and Projected State Government General Fund Revenues Compared to Simulated, Arizona, 1985 Through 2015* (Dollars in Millions)



* Fiscal year 2010 through 2015 revenue figures are projected, as is calendar year 2009 through 2014 GDP.

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

Figure 16.4
Actual and Projected State Government General Fund Expenditures Less Simulated Revenues, Arizona, 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).

this section. For either option to succeed, the existing structural deficit must be eliminated through some combination of spending reductions and/or revenue enhancements. It is assumed in the first alternative that revenue enhancements make revenue less cyclical and more responsive to economic growth.

The First Alternative

This alternative maintains general fund revenues at a nearly consistent share of Arizona's gross domestic product and ties spending increases to a formula.

Revenues

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 on average keeps pace with economic growth, averages a particular percentage of the state's GDP, and does not vary too widely in any year from the target percentage. This would minimize the size of cyclical budget deficits and allow the rainy-day fund cap to be less than in the second alternative.

Arizona's revenue flows currently are more cyclical than in the past (see Figures 10.2 and 10.3) and more volatile than in other states. Revenue flows that are no more cyclical than the economy are not achievable because of the strong cyclical nature in several of the possible revenue sources. However, it *is* possible to substantially reduce the cyclical nature currently being experienced.

As seen in Table 7.2, three revenue sources—sales and use, individual income, and corporate income—account for 90% of the state's general fund revenues. Each of these sources is far more volatile than is the state's economy, as seen in Figure 10.4. Further, ongoing revenues from these sources have not kept pace with the expansion of the economy.

As discussed in Chapter 15, various options exist to improve the revenue system. Any changes made should be in accordance with the revenue system guiding principles discussed in Chapter 11. The following discussion is based on a set of changes designed to maximize stability, responsiveness, and predictability—three of the 10 guiding principles.

Assume for the purposes of this illustration that in 1992 the costs of government services were met by the revenues generated; this is the starting point for this example. Cyclical nature from each of the three major sources could be reduced:

- **Sales and use tax:** Eliminate the volatile contracting sector from the tax base. Replace it with a tax on certain services and on food to be consumed at home. The selective sales tax on alcoholic beverages also could be increased.
- **Individual income tax:** Replace the existing rate structure with a flat tax based on 3% of Arizona adjusted gross income excluding the extremely volatile capital gains income.
- **Corporate income tax:** Reduce the reliance on this tax by cutting the tax rate to 3%—equal to the individual income tax.

In addition to these changes, a fourth major source of revenue to the general fund could be added by reinstating the statewide property tax, set to yield \$500 million in 2008. A uniform

assessment ratio could be applied to all property classifications. The statewide property tax rate could be changed over time to grow with the pace of the overall economy.

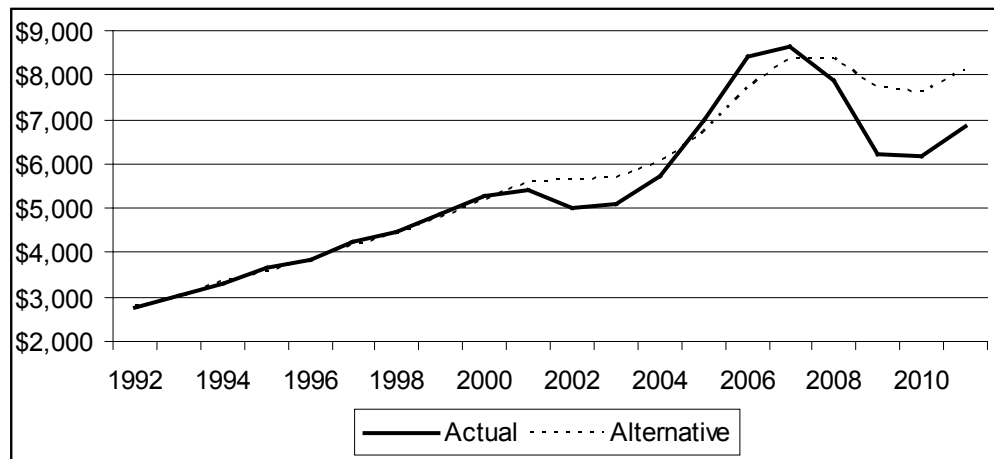
Figure 16.5 portrays the actual pace of revenue collections from the three existing major taxes compared to the collections that would have occurred had these tax rate and base changes been made to these three taxes and had the fourth major tax source been in place. The two revenue streams would have generated nearly identical amounts through the economic expansion of the 1990s. Since then, the proposed system would have been considerably less volatile and would have produced appreciably higher revenue during the recessionary and slow recovery periods from 2001 to 2004 and starting in 2008.

Numerous variations on this theme are possible, including adjusting tax rates to yield lower or higher revenue streams and adding individual income tax exemptions to help mitigate regressivity introduced by a flat income tax rate and the inclusion of food in the sales tax base. The purpose has been to demonstrate that it is possible to substantially reduce the volatility in general fund revenues. The overall cyclicality of general fund revenues also could be reduced by a greater dependence on user fees. Chapters 9 and 14 have demonstrated that user fees in Arizona are underutilized relative to western states and the U.S. average.

Expenditures

The spending side of the proposal is to control the growth of expenditures from the general fund to the pace of the overall economy, by implementing a spending rule of population growth plus inflation plus real per capita economic growth, with the latter based on GDP or a similar economic measure. The tax burden as a share of the economy would be stable in this situation. This spending rule would be consistent with the existing constitutional expenditure limitation, which is set as a percentage of personal income.

Figure 16.5
State Government General Fund Ongoing Revenues From Major Sources, Arizona, Fiscal Years 1992 Through 2011 (Dollars in Millions)



Source: Based on Arizona Joint Legislative Budget Committee.

Core expenditure needs could be met by spending growth at the pace of inflation and population. The portion of the rule tied to real per person economic growth (close to 2% per year) allows for productivity-enhancing investments to be made (such as purchasing improved computer technology) and for other needs to be met (for example, expanded spending for education or to build/refurbish infrastructure).

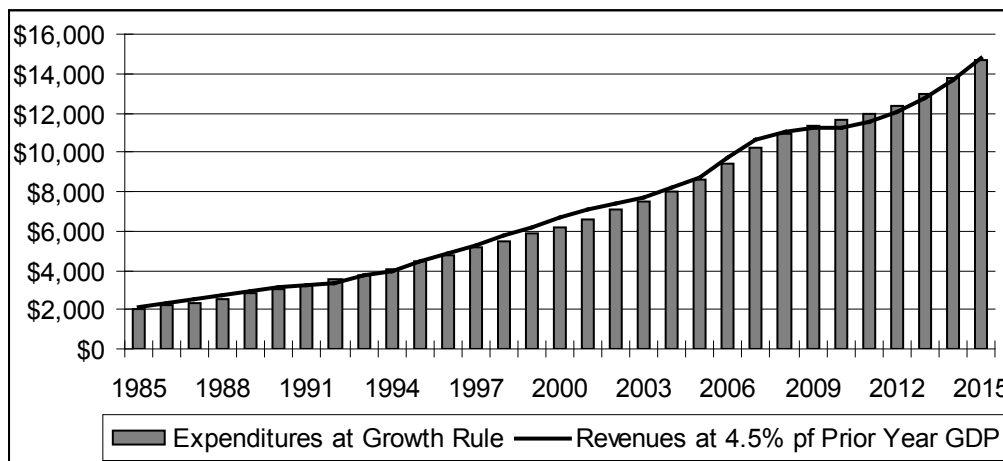
Simulation Results

A simulation was created in which revenue to the general fund equals 4.5% of the GDP in the prior calendar year, the average from 1971 through 1995. The revenue simulation could be based on aggregate personal income or other measures of the aggregate growth in the Arizona economy rather than GDP. Spending grows at the sum of population growth, inflation, and the average per capita real growth of the economy.

Figure 16.6 compares revenues and expenditures based on the revenue and spending rules. The simulation suggests that trend spending and revenue would have been more than \$11 billion in fiscal year 2009, compared to the revised budget of \$9.4 billion, and actual ongoing general fund revenue that was less than \$7 billion. The large difference between the trend line and actual revenue in part is due to the severe economic downturn. Still, due to the significant cumulative effect of the tax reductions since the early 1990s, to return revenue to the trend line of 4.5% of GDP would require considerable revenue enhancement.

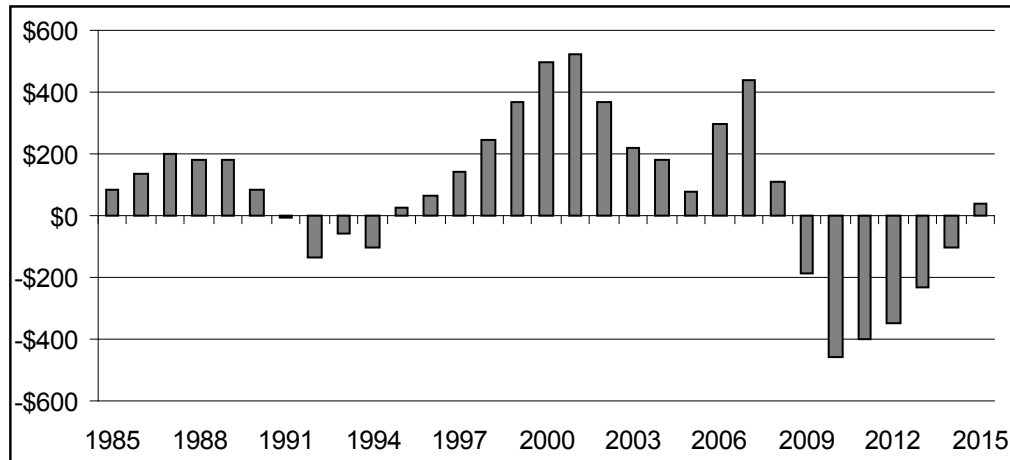
Since the revenue base is pegged directly to nominal GDP and the spending base also is effectively tied to economic growth, fiscal imbalances, shown in Figure 16.7, are small in comparison to what the state has actually experienced. Had the state had a rainy-day fund of

Figure 16.6
Simulated State Government General Fund Revenues
at 4.5% of State Gross Domestic Product and Expenditures,
Arizona, 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).

Figure 16.7
Simulated State Government General Fund Revenues
at 4.5% of State Gross Domestic Product Less Expenditures,
Arizona, 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).

10% of the general fund, an ample supply of cash would have been available to offset the deficits in the early 1990s. The rainy-day fund would not have been needed in the next economic downturn (in 2001-02). However, during the current severe economic downturn, the deficits projected from 2009 through 2014 would equal 17% of the general fund at the beginning of the downturn.

The Second Alternative

This alternative assumes that changes to the existing revenue system are not made. Instead, substantially more money is deposited in the rainy-day fund—the budget stabilization fund (BSF). The key provision of this alternative is to better use the rainy-day fund and to add other contingency funds.

The BSF is discussed in Chapter 17. 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. 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.

However, even if deposits to the BSF are increased such that the fund attains a 15% balance (as in the original legislation) 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 to 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% from the BSF would be required to balance the budget.

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. A contingency fund under the discretion of the Legislature could be created to handle such spending needs. 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.

Some expenditure fluctuations are predictable. The loss of jobs and income that occurs during inevitable recessions 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%.

In years in which surpluses remain even after transfers to the rainy-day fund and other contingency funds, two options exist: a rebate to taxpayers or one-time spending. Tax experts insist that the existence of a temporary surplus should never prompt a permanent tax cut or spending increase.

Dennis L. Hoffman is a professor of economics at Arizona State University. He has published numerous academic articles and a book on macroeconomics and econometrics. Professor Hoffman has received teaching and research awards, including the Distinguished Faculty Research Award in 1992 and Arizona Professor of the Year (by the Carnegie Foundation) in 1997. He has carried the title of Dean's Council of 100 Distinguished Scholar since 1996. In addition to his academic appointment, Dr. Hoffman is director of the L. William Seidman Research Institute and faculty director of the Center for Competitiveness and Prosperity Research in the W. P. Carey School of Business, as well as director of ASU's Office of the University Economist. Dr. Hoffman's sponsored research efforts include the construction and maintenance of the tax revenue forecasting model used by the Governor's Office of Strategic Planning and Budgeting since 1982. Dr. Hoffman headed groups of economists who measured the economic impact of several fiscal initiatives for "Fiscal 2000" in 1989. In 2003, he served as technical advisor to the Citizens Finance Review Commission. Dr. Hoffman has conducted considerable contract research over the last several years for a host of business and public organizations across Arizona. He earned his doctorate in economics from Michigan State University.

¹ Gross domestic product and personal income are available from the U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/>. Adjusted gross income is available from the Arizona Department of Revenue.

² Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm>.

³ Tax Foundation, <http://www.taxfoundation.org/news/show/335.html>.

Chapter 17

BUDGET STABILIZATION FUND

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KEY POINTS

- All 50 states have some form of a budget stabilization fund (“rainy-day” fund), with a wide variety of provisions and rules or methods for deposits and withdrawals.
- Arizona’s budget stabilization fund (BSF) was established in 1990. It was designed to smooth out cyclical fluctuations in revenue to the Arizona state government general fund.
- Significant changes have been made to the BSF since the original legislation. In particular, the original design of the BSF allowed it to have a balance equal to 15% of the general fund, but the current cap is only 7%.
- In each of the two recessions since the creation of the BSF, the available funding was substantially inadequate to offset the cyclical declines in revenue and thereby prevent large spending reductions.
- Relative to its stated purpose of smoothing the revenue stream, the BSF has too small a cap, the BSF formula does not transfer enough monies into the fund during periods of budget surpluses, a change in legislation restricts withdrawals from the fund, and the BSF has been used for expenditures not related to the business cycle.
- An adequately designed BSF not only provides revenue and stimulates the economy during periods of economic decline, but restricts the passage of permanent tax cuts and spending increases during periods of temporary budget surpluses.

INTRODUCTION

In the private sector, an economic slump reduces demand for goods and services. The drop-off in sales leads to a general reduction in business activity, frequently resulting in layoffs of personnel no longer needed.

In the public sector, however, most public functions experience only a small reduction in the *rate of increase* in demand during recessions. Most government functions are tied to the population, which continues to grow (though less rapidly) during an economic slump. For example, the number of students to educate does not decline, nor does the need for police, fire, and correctional services. While the demand for a few services falls off, such as inspections of buildings under construction, demand for some public-sector functions is countercyclical. For example, the demand for unemployment insurance benefits rises during recessions, as does the number of people eligible for public welfare. Enrollment in community colleges and universities frequently increases during slumps because of limited employment opportunities.

Thus, unlike the private sector, an economic slump does not lead to a decline in the demand for services in the public sector. However, government revenue collections are highly

cyclical, falling during economic downturns. Therefore, it is especially important for the public sector to have funds set aside to offset revenue decreases during an economic decline. In order to minimize the need to enhance revenue and/or reduce spending during an economic downturn, all states have adopted a budget stabilization fund (sometimes called the “rainy-day fund”).

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

Other States’ Stabilization and Emergency Funds

All states have some form of budget stabilization fund, but there is a wide variety in procedures for transferring monies to and from the fund and in the maximum amount that can be deposited in the fund (the “cap”). The limits, when expressed as a percentage of the general fund, tend to be between 4–15% of the general fund or budgeted revenues, but Utah and Wyoming have no cap on their stabilization funds.

A very few states express their limit as a fixed dollar amount. Some states make deposits into their stabilization fund by requiring a percentage (say 50%) of unanticipated revenue surpluses to be deposited into the fund, some mandate a percentage of general fund appropriations of revenues go to the fund, and others make annual appropriations to the fund. Funds may be controlled by the legislature, the governor, formula, or some combination.

Most states also have a fund for unexpected natural or man-made disasters. These are usually under the control of the governor or an emergency management agency within the administrative branch of government.

THE BUDGET STABILIZATION FUND IN ARIZONA

The severe cyclicity of the Arizona economy and the composition of the state’s revenue sources cause revenue collections to be more cyclical than in the average state (see Chapter 10). Thus, the existence of a rainy-day fund is of particular importance in Arizona. In fact, various analysts have suggested that strengthening Arizona’s budget stabilization fund may be the most important improvement that can be made to the state’s fiscal system. Marshall Vest makes this point at the end of Chapter 10. According to Elliot Pollack, “Above all else, implement a budget stabilization fund at least equal to the originally recommended 15% of prior year general fund expenditures.”¹

The Arizona Legislature created a budget stabilization fund (BSF) in 1990 (a year with a substantial general fund deficit). The BSF was designed by the Arizona Joint Legislative Budget Committee (JLBC) to set aside revenue during times of strong economic growth to be spent during periods of weak growth or recession. Transfers are between the BSF and the state’s general fund. The BSF is administered by the state treasurer.

A budget stabilization fund is an important tool for the fiscal management of the state general fund because:

- The state must maintain a balanced budget even during severe economic downturns.

- Arizona’s revenue structure is extremely cyclical, partly because of its mix of revenue sources and partly because of the strong cyclicity of Arizona’s economy.
- The health and welfare component of state expenditures is countercyclical, increasing during difficult economic times and decreasing during strong growth periods.

Current key features of the BSF have been outlined by the Arizona Senate research staff.² Some of the following is verbatim from their background report; other portions have been expanded for explanation:

- The deposit into or withdrawal from the BSF for a given fiscal year is determined by comparing the “annual growth rate” of inflation-adjusted “Arizona Personal Income” (AZPI) for the calendar year ending in the fiscal year to the “trend growth rate” of inflation-adjusted AZPI for the most recent seven calendar years.
- AZPI in the BSF formula is defined as total Arizona personal income minus transfer payments. Transfer payments are a component of personal income that consists of payments to persons by governments and businesses for which no current services are performed. Major examples of transfer payments include retirement and disability insurance payments; certain medical benefits and reimbursements; income maintenance benefits (such as Social Security payments or food stamps); unemployment insurance benefits; veterans benefits; and federal education and training benefits. Transfer payments are subtracted from Arizona personal income because the size of these payments does not reflect the condition of Arizona’s economy; in some instances, the transfer payments are counterindicative of Arizona’s economy.
- AZPI is adjusted by the gross domestic product implicit price deflator in order to remove the effects of inflation.
- The “annual growth rate” is the growth rate of adjusted AZPI in the calendar year that ends in the current fiscal year compared to the previous calendar year.
- The “trend growth rate” is the average of the previous seven calendar-year growth rates of the adjusted AZPI.
- If the annual growth rate exceeds the trend growth rate, the excess multiplied by the general fund revenue of the prior fiscal year equals the amount recommended for deposit into the BSF. Thus, if the annual growth rate is 6% and the trend growth rate is 5%, then 1% of the prior fiscal year’s general fund revenue would be recommended for deposit into the BSF.
- If the annual growth rate is both less than 2% and less than the trend growth rate, the deficiency multiplied by the general fund revenue of the prior year equals the recommended amount to be withdrawn from the BSF. Thus, if the trend growth rate is 5% and the annual growth rate is 2%, nothing would be withdrawn from the BSF. If the trend growth rate is 5% and the annual growth rate is 1%, then an amount equal to 4% of the previous year’s general fund would be withdrawn from the BSF, assuming it has an adequate balance.
- By a two-thirds majority, the Legislature, with the concurrence of the governor, can decrease a signaled deposit or increase a recommended withdrawal.
- At the end of a fiscal year, the BSF’s total balance cannot be larger than 7% of that year’s general fund revenues.

- In addition to the fixed income investments available to the treasurer, the Legislature in 1998 allowed the treasurer to invest up to 25% of the BSF in equity securities.

The Arizona BSF is unusual in that it is formula driven. Only a few states have similar arrangements for their rainy-day funds.³ While subject to legislative appropriations for deposits and withdrawals, the BSF formula provides both a signal and suggested dollar amount of deposits to the BSF in “above average” economic times and fund withdrawals during “below average” economic times.

The Arizona Economic Estimates Commission (EEC) meets in the spring (the last quarter of each fiscal year) to calculate the annual growth rate and the trend rate in AZPI, and to determine the formula-driven appropriation to, or transfer from, the BSF. The commission must complete, certify, and report its findings to the governor, the state treasurer, the president of the Senate, the speaker of the House of Representatives and the JLBC prior to June 1. The EEC calculations do not result in automatic BSF deposits or withdrawals; rather, they are recommended amounts to be appropriated or withdrawn subject to legislative action.

The timing of the EEC meeting creates practical difficulties. First, formula-driven recommendations for a given fiscal year that cannot be made until near the end of the fiscal year can create cash-flow problems during a fiscal year with a weak economy. Second, the formula that determines the transfers for the current fiscal year is based on data for the period 6–18 months prior to the end of the fiscal year. Economic conditions can change rapidly within a given six-month period, so the formula-driven recommended transfers to, and withdrawals from, the BSF may not reflect current economic conditions or expected future conditions.

In reality, the Legislature requires information about revenues and expenditures, and estimates of needed withdrawals or likely required deposits into the BSF, before the spring. In periods of economic growth, the EEC formula recommendations tend to be used to determine deposits into the BSF, assuming the cap has not been reached. However, in periods of economic downturn, the Legislature must use its two-thirds discretion to access BSF money during the fiscal year.

Changes from the Original BSF Statute

Three key features of the operation of the BSF differ from the original 1990 design. First, the balance of the BSF currently is limited in size to 7% of the prior year’s general fund revenues, but under the original 1990 statute, the balance could reach as much as 15% before deposits to the fund would be stopped. The 15% size of the cap had been calculated by the JLBC using prior business cycles and revenue collections to be the amount necessary to smooth Arizona’s revenue flows through a modest recession. Despite the original determination of a 15% ceiling, the Legislature reduced the size of the cap to 5% from 1995 through 1997 before gradually increasing it to 7% in 2000.

Second, another change made in the mid-1990s was adding the condition that withdrawals from the BSF would only be made if the annual growth rate in AZPI in the prior calendar year be *both* below the trend line and below 2%. Presumably, the 2% floor was added to

avoid withdrawing monies when economic growth is slowing but not yet in a recession. This requirement results in the formula sometimes failing to recommend payouts during downturns. For example, in both 2002 and 2008, the formula did not recommend payouts because the adjusted AZPI was 2.10% and 2.88%, respectively. In both cases, the Legislature authorized substantial withdrawals from the BSF to close budgetary shortfalls.

Third, despite the BSF being designed solely as a management tool to smooth the fluctuations in the business cycles, it has been used as a contingency fund for other types of fiscal emergencies or requirements. In 1999, the Legislature allowed the BSF to provide partial funding for major renovations to the Arizona State Hospital. In 2000, legislation was passed that required liabilities related to the alternative fuels legislation to be funded by the BSF up to \$200 million. The BSF was to be reimbursed by the general fund at a rate of up to \$16 million annually, but this reimbursement provision was repealed. From 2001 through 2007, the BSF financed unplanned taxpayer refunds associated with the alternative fuels program of about \$119 million, according to the JLBC.

PERFORMANCE OF THE BSF

The first payment into the BSF was made in fiscal year 1994. In the next fiscal year (the one in which the limit was dropped to 5%), the cap already was reached. In the next two fiscal years (1996 and 1997), the formula called for a transfer to the BSF, but no deposit was made to the fund because of the 5% limit. While the dollar limit of the BSF rose gradually each year because of the increasing size of the general fund (before adjustment for inflation or population growth), the fund's interest earnings kept the balance at the limit. In fiscal years 1998 and 1999, the gradual increase in the percentage limit from 5-to-7% allowed some deposits to be made to the fund, though less than those indicated by the formula. With a weakening economy, withdrawals from the BSF began in fiscal year 2001. The total transferred to the general fund from fiscal years 2001 through 2003 was \$455 million, some \$339 million less than called for by the formula. Substantial spending reductions had to be implemented in order to balance the general fund budget.

An improving economy caused the formula to indicate that a small deposit to the BSF should be made in fiscal year 2004, though this was not done. However, large deposits to the BSF from fiscal years 2005 through 2007—during the economic expansion—again pushed the reserve to the 7% maximum allowed. Most of this was used in fiscal year 2008, leaving little to balance the fiscal year 2009 budget, which was billions of dollars out of balance. Thus, in each of the two economic downturns since the creation of the BSF, its balance was substantially inadequate to offset the general fund budget deficit.

No reasonably designed budget stabilization fund could have completely avoided the current fiscal crisis in Arizona, because of the unusual length and depth of the recession that began late in 2007. However, the BSF, as currently designed, also failed to adequately serve the needs of the state in the more typical 2001 recession. The fund is limited to 7% of the general fund, but the three major sources of revenue can fall by an amount closer to 8% *per year* during a normal recession. If population growth and inflation are at normal recessionary levels, then the 8% decline in revenues reflects a 12–14% reduction in the state's ability to provide services to the ever-growing population in an increasingly expensive environment.

To make matters worse, recessions typically impact more than one fiscal year's budget. Recessions commonly impact revenues for three years, with slow growth one year, negative growth the next, and flat or slow growth the third year. Thus, even with the original 15% cap, the funds in the BSF may not be sufficient to offset the loss of revenue during a recessionary period.

With the 7% cap on Arizona's budget stabilization fund, and the below-2% requirement for annual growth before tapping the BSF, Arizonans can expect that services will be cut during the slowdown year prior to the recession, again during the first year of the recession despite using up the entire budget stabilization fund, and yet again during the third year because the flat or slow growth in revenues will not keep up with population growth and inflation, much less the continuing increase in demand for public welfare services.

ISSUES WITH THE BSF

Simulations of the operation of the BSF reveal several weaknesses in the current BSF statute. First, capping the BSF at 7% of the general fund provides a substantially inadequate amount of monies to transfer to the general fund during a typical economic downturn. The Citizens Finance Review Commission in 2004 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% cap and take measures to make 'raids' on the fund more difficult."

Second, even if the cap is returned to 15%, as in the original legislation, the fund will rarely, if ever, achieve such a balance based on the formula-dictated transfer to the fund during years of strong economic growth. Thus, in a typical economic expansion, the fund balance will fall well short of 15%, particularly if the fund balance during the prior economic recession dropped to zero or only a few percent of the general fund.

Third, the transfer formulas may be too conservative to provide for substantial payouts during downturns. The "less than 2% growth" requirement has resulted in \$0 withdrawals recommended by the EEC even during severe recessions. The Legislature overruled this requirement in both 2002 and 2008. This rule was not in the original design of the BSF. During previous economic downturns, Arizona's population continued to grow by 2% or more, making this requirement almost impossible to meet.

Fourth, the BSF has been raided for unplanned expenditures not related to the business cycle. Some states have a variety of emergency and contingency funds designed to cover fiscal emergencies unrelated to fluctuations in the business cycle. In addition, ad-hoc rather than the formula-recommended transfers to and from the fund have been made. These issues could be resolved by specifying the operation of the BSF in the Arizona 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% of general fund revenue would generally ensure the effectiveness of the BSF.

Without such a constitutional provision, revenue cyclicity can contribute to long-term structural deficits through the actions of government leaders. During strong growth periods that have resulted in temporary budget surpluses, politicians have given back the surpluses to

taxpayers by cutting tax rates permanently, limiting the size of the BSF, and expanding public programs. During the 1990s, the Arizona Legislature cut taxes repeatedly and reduced the cap on the BSF. More tax reductions were passed during the mid-2000s, and expenditure commitments grew. Both sets of actions contribute to long-term structural deficits and increased financial instability. A requirement to place excess monies into the BSF would preclude making permanent tax cuts without commensurate reductions in spending and also would prevent permanent increases in spending without identifying a new revenue source.

Both politicians and voters tend to have a short-run view of the budget and large rainy-day fund balances become a target when memories of the last downturn have faded. The National Association of Budget Officers (NASBO) suggests that multiyear budgeting and forecasting may provide a framework for political discipline and avoiding the turbulence created by budget cuts during recessions. The true costs of new spending and tax reductions are more easily understood when costs are shown for more than the current budget period.⁴

If the BSF were fully funded and the state still experienced a budget surplus, the excess revenue dollars could be rebated back to taxpayers rather than permanently cutting taxes during periods of rapid, but temporary, revenue growth. However, if the BSF were capped at 15% or more, such a situation is unlikely to occur.

Recessions and business cycles are an economic reality. The BSF is an excellent tool for fiscal management. It is important for voters, politicians, and policymakers to understand that a fully funded BSF will help prevent the public sector from having to make spending cuts to popular programs during the next recession, and will help the entire state economy by acting as a strong countercyclical stimulus. The expenditure of the BSF during a recession provides direct stimulus to the state by avoiding substantial reductions in the government sector at a time when other segments of the economy are weak and by avoiding major cuts in health and welfare benefits that can have between a 1-to-1 and a 6-to-1 federal-to-state match. This federal flow of funds into Arizona can also act as a strong countercyclical force.

OTHER EMERGENCY FUNDS

Other than the BSF, two other stabilization funds have been created in Arizona.⁵ The medical services stabilization fund is to be used if the appropriations for Arizona's Health Care Cost Containment System (AHCCCS) are insufficient in a fiscal year to cover the cost of AHCCCS medical services (Arizona Revised Statutes 36-2922).⁶ This medical emergency fund receives transfers from the medically needy account of the tobacco tax and health care fund. It has had a zero balance since fiscal year 2004.

The temporary assistance for needy families (TANF) stabilization fund was established in 1997 to supplement existing appropriations when caseloads for the TANF program exceed budgeted projections. The TANF emergency fund has had a zero balance since fiscal year 1999.

In one national report, Arizona is listed as having a governor's emergency fund to be spent only on man-made or natural disasters.⁷ However, there is no set-aside money for declared emergencies; rather, the governor is authorized to spend up to \$4 million in a fiscal year for

such emergencies, to be funded out of unrestricted general fund monies (Arizona Revised Statutes 35-192).

Alberta Charney is a senior research economist in the Economic and Business Research Center at the University of Arizona, where she is considered an expert on tax analysis, econometric model building, regional economic forecasting, and impact analysis. She has built numerous revenue and economic forecasting models for Arizona and its substate areas. Her diverse academic publications deal with transportation, taxation, econometric model building, forecasting accuracy, water issues, migration, manufacturing location, and entrepreneurship and have appeared in *Land Economics*, *Journal of Regional Science*, *International Regional Science Review*, *Review of Public Data Use*, *Journal of Urban Economics*, *Logistics and Transportation Review*, *Quarterly Review of Economics and Business*, *Resources and Energy*, *American Journal of Agricultural Economics*, *Western Tax Review*, *Regional Studies*, *State and Local Government Review*, the *International Journal of Entrepreneurship Education*, and contributed book chapters. Dr. Charney received an undergraduate double degree in Mathematics and Economics from Carnegie-Mellon University and her master's degree and doctorate in Economics from the University of Illinois in Champaign-Urbana. She has been a faculty member in the Economic and Business Research Center since 1977.

¹ See the executive summary of *Arizona's Optimal Tax Structure—A General Overview* (July 2003), prepared for the Citizens Finance Review Commission.

² Arizona Senate Research Staff, "Arizona's Budget Stabilization Fund" (November 5, 2008), <http://www.azleg.gov/briefs/Senate/BUDGET%20STABILIZATION%20FUND.pdf>.

³ National Association of State Budget Officers, *Budget Processes in the States* (Summer 2008), <http://www.nasbo.org/Publications/PDFs/2008%20Budget%20Processes%20in%20the%20States.pdf>.

⁴ National Association of State Budget Officers, *Budget Stability: A Policy Framework for States* (July 1995), <http://www.nasbo.org/Publications/PDFs/budstab1995.PDF>.

⁵ Arizona Joint Legislative Budget Committee, "Arizona Budget Stabilization Funds," <http://www.azleg.gov/jlbc/budstab.pdf>.

⁶ The Arizona Revised Statutes can be accessed at <http://www.azleg.state.az.us/ArizonaRevisedStatutes.asp>.

⁷ National Association of State Budget Officers, *Budget Processes in the States* (Summer 2008), <http://www.nasbo.org/Publications/PDFs/2008%20Budget%20Processes%20in%20the%20States.pdf>.

Chapter 18

OPINIONS OF INTERVIEWEES: PRIOR EFFORTS TO IMPLEMENT REVENUE REFORM

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KEY POINTS

- The most significant public-sector accomplishments in Arizona during the last 30 years have featured strong political leadership from both the executive and legislative branches, and bipartisanship. However, few of these achievements have occurred during the last 20 years.
- Support from business and community groups that have political power and the financial ability to advocate for change is critical to the success of any initiative.
- Whether the proposal will be voted on by legislators or by voters at the ballot box, making the case for reform—garnering public support—is essential. This requires organization, a clear message, funding, and a broad coalition of support from leaders.
- Many of the most significant successes have been driven by external pressures, such as a court mandate, or a general consensus that the existing system has significant problems.
- In contrast to the successes, comprehensive revenue reform efforts have failed. The broad and intangible nature of revenue reform makes success more difficult.
- Comprehensive reform of any kind is more difficult to achieve today than two decades ago because of institutional factors such as term limits, noncompetitive legislative districts, public campaign financing, and the supermajority requirement for a net increase in revenue.
- Other barriers to change include an erosion of party discipline and a decline in the quality of leadership since the Bruce Babbitt/Burton Barr/Alfredo Gutierrez era. Institutional changes such as term limits and Clean Elections have shaped a different system from that of the past.
- Cultural barriers also make it difficult to pass major legislation. However, the lack of business leadership and a “Wild West” frontier mentality have not inhibited cohesive, comprehensive policymaking in local governments.

INTRODUCTION

This chapter focuses on the *process* needed to achieve comprehensive revenue reform. In order to determine what actions would be required to improve the revenue system, an examination of public policy successes and failures during the last 30 years was undertaken. In addition to accessing printed materials, this examination was conducted by interviewing 24 individuals familiar with the legislative process in Arizona. Most of those interviewed have been observers/participants in Arizona politics for many years, and most were close observers of prior efforts to reform the state’s revenue system. None of these individuals have held elected office, though some have served as legislative staff or in other positions in state government. None currently are employed by the state.

Those who were interviewed agreed to be identified (see Appendix 1), but were assured that their individual positions on the issues would not be revealed. Thus, unattributed quotes that appear throughout this chapter were made by those interviewed.

This chapter largely represents the opinions of those interviewed, but does not reflect the opinions of the author or of the Arizona Town Hall. However, not all of those interviewed agree with all of the content in this chapter.

NONREVENUE REFORM

Legislative actions that have focused on issues other than revenue reform offer insight into the processes behind successful initiatives. In addition to questions specific to earlier efforts to change the revenue system, those interviewed were asked to identify major nonrevenue reforms that succeeded and the critical factors that led to their success. Many of the successful nonrevenue reforms during the past three decades were driven by extreme circumstances or external mandates.

Groundwater Management Act (1980)

Bruce Babbitt, Governor of Arizona from 1978 to 1987, was instrumental in coordinating the passage of the Groundwater Management Act (GMA). According to the *Washington Monthly*, this was “the single most important reform given its comprehensiveness and boldness.”¹

Though the severity of Arizona’s water shortage was well known, efforts to address the issue had failed. In 1976, the Arizona Supreme Court forced politicians to act by ruling that a landowner could not transport water from one area to another if by doing so another party was injured, for instance by lowering the water table.

In response, the Legislature established a Groundwater Management Study Commission, whose members were divided meticulously between cities, mines, and farmers. It gave the commission unusual powers: if the Legislature failed to pass a groundwater depletion bill by September 7, 1981, the commission’s proposal would automatically become law.

Factors that contributed to the success of the Groundwater Management Act include:

- Closely following the 1976 Supreme Court decision, the time was right for major reform. External pressures and political conditions were well aligned.
- From the beginning, there was a general consensus among key stakeholders—ranchers and farmers, cities, tribes, and the development community—that water policy reform was critical.
- With the support of key legislators (who were willing to compromise), the activist Governor Babbitt got the commission members together in a Phoenix conference room and told them they could not quit until they had developed a proposal.
- This stakeholders group created an “all-or-nothing” package that the Legislature had to accept or reject in whole, in an up-or-down vote; the Legislature could not change one comma of what had been agreed upon.
- The bill moved without debate through the Legislature to the governor’s desk because key legislators who could move the bill quickly were on board from the beginning.

- Media who understood the issues and were able and willing to communicate them to the public.

Many of those interviewed suggest that these key ingredients have not existed since the days of Bruce Babbitt (a Democrat) and Burton Barr, House majority leader (a Republican). While lessons to be learned from the success of nonrevenue reforms like the Groundwater Management Act exist, some suggest that revenue reform is far more difficult because it goes to the core philosophy of government. Water policy does not engage voters the way tax policy does. Taking a stance on water policy was not the kind of political risk (in terms of upsetting one's constituents) that taking a stance on tax policy could be.

Urban Lands Act and the Arizona Health Care Cost Containment System (1981)

Together with legislative leadership that included Burton Barr and Senate Minority Leader Alfredo Gutierrez (a Democrat), Governor Babbitt drove a number of other important, comprehensive reforms during his tenure, including the Urban Lands Act and the Arizona Health Care Cost Containment System (AHCCCS).

Passed in 1981, the Urban Lands Act “enabled the State Land Trust to capitalize on the large increase that planning and zoning adds to raw land values by leasing and selling state trust lands. Today the Land Department’s urban lands lease and sale program is the largest revenue producer for the Trust.”²

Authorized by the Legislature in 1981, AHCCCS was at the time viewed as a leading, innovative reform; it was viewed as a model for managed care. “Arizona ... decided it needed a piece of the federal Medicaid pie but not under the standard federal conditions. Arizona legislators took their state’s clean slate and drew up their own blueprint for a Medicaid system.”³

The successes of the Urban Lands Act and AHCCCS can be attributed to a number of factors, including:

- Complete commitment and a willingness to compromise from Governor Babbitt and the Legislature (in particular, Burton Barr).
- Bipartisanship that “the state wouldn’t recognize today.” (Today’s environment is characterized by “partisanship and one-upmanship, which does not lend itself to reform”).
- In the case of AHCCCS, Arizona’s counties were overwhelmed by the obligation to care for their indigent populations, creating a sense of urgency and great motivation for reform.

Students FIRST Act (1998)

In *Roosevelt v. Bishop* (1994), the Arizona Center for Law in the Public Interest alleged that “the manner in which Arizona public schools were funded for school construction resulted in huge inequities between the facilities in poor school districts and those in wealthier school districts.”⁴ The state Supreme Court found that the property tax-based school financing system was unconstitutional. Secondary property taxes on local school districts’ assessed property values could no longer be the mechanism for funding public school construction.

The Legislature's first two attempts to resolve the issue were found by the Court to have failed the constitutional test. The Legislature's third attempt, the Students FIRST Act, replaced voter-approved general obligation bonding (financed by property taxes) as the first source for school construction with a centralized state funding system. It "moved the financial burden of paying for public school construction and renovations from the local taxpayer to the state."⁵

Moving the funding for school construction to the state's general fund without increasing revenue is widely cited as one of the causes of the state's current fiscal difficulties. The passage of Students FIRST occurred because:

- The Court had ruled the current, local-government property tax system unconstitutional as a means of financing school construction.
- Two prior efforts to find a solution acceptable to the Court had failed.
- The business community, which felt that business property taxes were too high, advocated for Students FIRST, hoping it would lower property taxes.
- Democratic legislators failed to come up with other viable alternatives for school financing.

COMPREHENSIVE REVENUE REFORM

Most interviewees were hard-pressed to suggest any *comprehensive* revenue reform efforts that were successful. The three state revenue reform efforts discussed in this section were comprehensive studies, but any reforms that they generated were piecemeal. To find a successful, comprehensive tax reform, the 1986 Federal Tax Act is examined.

Federal Tax Act (1986)

This act represented a huge reform of the federal tax code. According to the *Washington Monthly*, "Tax reform was the first dramatic confrontation in more than a decade in which the special interests, and the politics of selfishness they represent, lost to the public interest. No one seems to be eager to go through the same exercise again. Reforming the tax code meant forcing the political system to work against some of its most powerful tendencies. The success of tax reform is seen by many as an anomaly—a sort of political solar eclipse that required a peculiar political arrangement and is unlikely to repeat itself for a long time."⁶

Key success factors that made the Act possible include:

- A few key players in the right places to "set things in motion so that even those disposed toward fighting reform see their own interest in backing it."⁷
- Senator Bill Bradley-types able to fashion radical compromises that work.
- Making the case to the public.
 - Reporters who understood federal programs well enough to see through press releases and distinguish fact from fiction.
 - "Outrageous anecdotes" were developed that the public could rally around and that were used to create a pervasive sense of injustice or unfairness, leading to a groundswell of public dissatisfaction that built momentum for change.
- A few policymakers, like Ronald Pearlman (assistant secretary for tax policy) and Charles McLure (Pearlman's deputy), who persuasively argued the case for ideal solutions.

- Jim Baker (secretary of the Treasury) and Richard Darman (deputy secretary) created “Machiavellian tactics to implement those ideal solutions.”⁸
- An appeal to the common good. “Tax reform’s most important victory is in showing that politically irresolvable dilemmas can be overcome by appeals to, and strategies aimed at, the common good.”⁹

Arizona Joint Select Committee on State Revenues and Expenditures (1989)

The charge of the Arizona Joint Select Committee on State Revenues and Expenditures (“Fiscal 2000”), which delivered its final report in November 1989, was “to identify structural weaknesses in Arizona’s current fiscal structure and to recommend a fairer, simpler, more predictable fiscal system.”¹⁰

The committee was established by government leaders in a collaborative fashion. “Just getting agreement to hold Fiscal 2000 was a challenge. It required a lot of skill to put together a group that was not immediately discredited.”

While the comprehensive, systemic changes recommended by Fiscal 2000 were not implemented, the structural budget deficit identified by the committee was resolved through a combination of spending reductions and tax increase. (A new structural deficit has since been created.) In addition, some of the property tax changes recommended by the committee were implemented because:

- The utilities, which had the political power and financial ability to advocate for change in the Legislature, backed the reforms (supported by local businesses).
- The reform was politically palatable because the business property tax was reduced while the property tax of homeowners was capped.

Tax Reform for Arizona Citizens Committee (2002)

The Tax Reform for Arizona Citizens Committee (TRACC) was established in 2002 to “examine the current tax structure, focus on short-term problems and provide recommendations that can be immediately implemented to improve the state’s competitiveness.”¹¹ The committee was made up of legislators, local government officials, a school district representative, and private citizens representing taxpayers and businesses.

While the committee and its charge were comprehensive, changes to the revenue system that resulted were piecemeal. The business property tax rate was very high compared to the homeowners’ property tax rate. TRACC constructed a plan to decrease the business property tax rate without raising the homeowners’ rate—the only way the reform would get enough support from the Legislature and governor. Thus, in order to accomplish the end-goal of lower business property tax rates, proponents had to accept an enhancement of property tax rebates for homeowners, a policy widely considered by experts to be ill-advised. It is often necessary to “work within the political realities to accomplish change.”

TRACC was successful in driving piecemeal changes to the revenue system because:

- The committee (and by extension, its recommendations) had buy-in from legislators.
- It relied on tax experts.
- Members were able to convince legislators that the recommendations put forth by TRACC made sense.

- The end-goal of a reduction in the business property tax rate was packaged as revenue neutral.

Citizens Finance Review Commission (2003)

The Citizens Finance Review Commission (CFRC) was established in 2003 by Governor Napolitano to “develop a series of recommendations that will advise the Governor on a course to stimulate Arizona’s economy for the long term. In particular, the Commission will develop recommendations that address fiscal and tax policies that are simple, low and fair and support Arizona’s growing economy.”¹²

In contrast to Fiscal 2000, the Citizens Finance Review Commission was established solely by the governor, who also selected the members. The CFRC was headed by high-profile business people.

The recommendations of the CFRC, like those of Fiscal 2000 and TRACC, are widely considered to be valuable insights into the issues associated with Arizona’s revenue system. Yet, like Fiscal 2000 and TRACC, the CFRC’s recommendations failed to result in comprehensive reform. In fact, the Republican-led Legislature hardly responded to the CFRC’s recommendations, in part because the force behind the CFRC (Governor Napolitano, a Democrat) was at odds with the Legislature.

The best Governor Napolitano could do was issue executive orders, which are a weak, limited, and temporary response. Citizens’ committees do not work when the governor does not follow through. Many suggest that there was no significant follow-through from Governor Napolitano in part because the economy was booming when the CFRC released its findings. Further, “it is very difficult for these committees to be effective because once the report is produced, the committee adjourns and there is no one left to carry the torch.”

Causes of the Failure of These Revenue Reform Efforts

“If the standard by which Fiscal 2000, TRACC, and the CFRC are measured is ‘What changed?’ then they were not successful.” The tough decisions, simply put, were not made. Some of the factors that contributed to the failure of Fiscal 2000, TRACC, and the CFRC to result in comprehensive revenue reform are:

- While each study produced useful policy information, no follow-up mechanism was present to drive reform.
- When study groups are convened in response to an economic or fiscal crisis or a groundswell of public dissatisfaction, the circumstances that drove an immediate need for reform often have passed by the time the committee releases its recommendations.
- While both Fiscal 2000 and the CFRC reached a high degree of consensus on the nature of the issues, these conclusions were incongruous with public perception. The chasm between what the study groups saw as the problems and solutions and what the public saw as the problems (or lack thereof) and solutions was too big a divide to bridge.
- Generally, the studies failed to answer fundamental questions such as:
 - What is state government’s role? What should it do? How much?
 - How much tax burden should be paid by individuals? How much should be paid by businesses?

- What share of the tax burden should be borne by high-income taxpayers?
What share should be paid by lower-income taxpayers?

The answers to those fundamental questions form the foundation for comprehensive reform. “The answers to those questions shape the conversation. We must talk fairly about revenue needs and balance in revenue structure, not in nakedly personal terms.” To successfully implement comprehensive revenue reform, the hard questions about the state’s philosophy of government must be addressed. “Revenue reform goes to the core of what people disagree about. That is the function of government to raise and spend money.”

PIECEMEAL REVENUE REFORM

The vast majority of major revenue reform efforts have failed because politics got in the way. In Arizona, many legislators have an ideological bias against tax increases. They say, “I don’t want to tax you or me, I’ll tax that guy behind the tree.” Often, revenue decisions are made based on answers to the questions: “Who will complain the loudest?” “Who has political influence?”

As a result, tax reform in Arizona has been comprised of a series of long, tedious, incremental steps made more difficult because stakeholder and leadership groups change over time. No overarching, consistent strategy was behind those piecemeal changes. “If sound, policy-driven analysis was the impetus behind reform efforts, then the state’s fiscal system would look much different today.”

Property Tax (1980)

In 1978, voters in California passed Proposition 13, which put a cap on homeowner property tax increases. Inspired by California and motivated by the high inflation throughout the 1970s that led to dramatic increases in property taxes, one Arizona group proposed an initiative for Arizona that was similar to Proposition 13.

Governor Babbitt and other Arizona leaders disagreed that a California-style initiative would solve homeowners’ tax woes. “Because [Arizona’s and California’s] tax systems were different, our officials knew that limiting valuation and tax hikes exactly as California had done could seriously harm Arizona, its local governments, and its school districts.”¹³

So the Democratic Governor and the Republican Legislature worked together in 1979 to develop a proposal that would reform the state’s property valuation and tax laws. They enlisted the help of business and community leaders and the media. They raised money to explain to voters the proposal, which included a constitutional amendment to limit increases in the homeowners’ property tax—to protect homeowners from “extreme” tax increases. The Legislature referred the reform proposal to the ballot for a public vote; it was passed in a special election in June 1980. In November 1980, the California-style proposition was on the ballot, but it was defeated by a substantial margin.

The June 1980 property tax proposal was successful because:

- Voters cared about the issue; property taxes had risen dramatically in the 1970s.
- There was a broad-based, well-financed, well-organized effort to back the reform with a well-financed outreach effort.

- The reform’s proponents—initially Governor Babbitt and legislative leaders—developed broad-based coalitions of support from business and community groups that took the message to the people.

Maricopa County Transportation Excise Tax (1985)

In October 1985, the voters of Maricopa County approved Proposition 300, authorizing the Maricopa County Transportation Excise Tax for a period of 20 years. Commonly referred to as the “1/2-cent sales tax,” the monies were dedicated to the county’s regional freeway system. In November 2004, Maricopa County’s voters approved Proposition 400, which extends the tax for another 20 years to be used for construction of new freeways, widening of existing freeways and highways, improvements to the arterial street system, regional bus service, and high-capacity transit services such as light rail.

Propositions 300 and 400 succeeded because:

- Reform proponents developed a broad coalition of support. Legislative leaders worked with the League of Cities and Towns to develop the proposal.
- The reform was highly targeted to transportation projects in Maricopa County.
- Benefits were tangible. Voters could easily understand the benefits they would enjoy with a new regional freeway system.
- The reform proposal was easily explained. Neither the method of generating revenue (the 1/2-cent sales tax) nor the expenditures (transportation projects) were particularly complex or esoteric.

Governor Symington’s Tax Decreases (1990s)

Governor Fife Symington’s tax decreases during the 1990s were driven simply by his desire to lower taxes, a desire matching that of many legislators. Like Governor Babbitt, Symington used the governor’s bully pulpit to achieve his agenda. Unlike Babbitt, Symington was not a consummate politician; his background was in business. He was an effective leader simply because he had a goal and he pursued it relentlessly. “A governor like Fife Symington can enact tax reform even if it doesn’t appear that the state can afford it. Most politicians have neither that strong a belief nor the political will.”

While many consider Symington’s tax decreases to be ill-advised, his success at making revenue changes can nonetheless be instructive. Activist governors like Symington and Babbitt, simply put, get things done. Successful leaders:

- Are knowledgeable. A strong, knowledgeable staff is critical.
- Are great communicators. Interestingly, Babbitt was not known for his public speaking talent (he was somewhat awkward), but in more personal settings he was both personable and highly influential.
- Cultivate strong popular support among legislators, business leaders, and community leaders. Strong, effective governors know how to bring people together.
- Use the governor’s office as a bully pulpit. “If you look at what I’ve done over the last ten years,” Babbitt told the *Washington Monthly* in 1988, “you will find that in any given year I have selected one or two or three issues and used everything at my disposal—initiative, referendum, the bully pulpit, the press, brow-beating, trade-offs, threats, rewards—to get what I needed. My agenda is concentrated and aimed at overwhelming the opposition.”¹⁴

Sales Tax Increase for Education (2000)

“One of the most productive efforts to increase taxes in Arizona,” Proposition 301 amounted to the largest tax increase in Arizona’s history. It was passed rather easily in 2000 after nine years of tax decreases driven largely by Governor Symington and fueled by legislators’ “no new tax” pledges.

“The creator and primary champion of Proposition 301 was Governor Jane Hull. She had, in fact, wanted to increase K-12 funding for some time prior to this measure ... her plan took its final shape as a referendum to be put before the voters in November 2000. The proposition would, among other things, create a six-tenths of 1% increase in the state’s sales tax for 20 years earmarked for purposes of public education.”¹⁵

The Proposition 301 campaign was well-run but was not particularly heavily financed. Yet it received a substantial majority of votes. It succeeded because:

- The governor was an advocate for change. A governor can exert a lot of influence, chiefly by setting the agenda.
- There was bipartisan support. Cultivating bipartisanship is hard to do, but most great reforms are bipartisan.
- Proponents built coalitions.
- The governor had smart staffers who worked hard and were on board with the reform.
- Like the Maricopa County transportation tax, Proposition 301 was targeted and tangible. It raised taxes for education delivered in the classroom, something voters could easily understand.

WHY COMPREHENSIVE REFORM HAS LARGELY FAILED

A number of factors conspire to make comprehensive reform of any kind more difficult today than two decades ago. Some, like term limits and Clean Elections, are institutional. Others owe to the simple fact that Arizona’s leaders are different today than they were 20 years ago, in large part because of those institutional factors. Cultural factors also work to make comprehensive reform more difficult.

Institutional Factors

Since the early 1990s, changes to the political system in Arizona have “fundamentally” altered the way state government functions. Their unintended consequences have crippled public policy making.

Term Limits (1992)

“Arizona, like many other states, got caught up in the term limit movement when voters in 1992 approved a measure limiting the terms of legislators at both the federal and state level . . . Most of the focus of the campaign was directed at Congress, largely out of frustration of a single political party dominance for more than 40 years. Yet, as in other states, the term limits that applied to the congressional offices were struck down in court, leaving only [state] legislators subject to term limits.”¹⁶

Arizona’s term limits law has largely been ineffectual at limiting the total number of years a person can serve in the Legislature because Arizona’s term limits law allows legislators to

switch between the House and Senate. While the number of terms they spend consecutively in any one chamber is limited, the total time they spend in the Legislature is not.

At the same time that the term limits law has not had the intended effect, it has had unintended consequences. For one, it has made legislative staffers and lobbyists more powerful because they are the ones who have the institutional knowledge that the legislative members lack.

Term limits also have contributed to rapid movement into leadership positions. Whereas before term limits a legislator might take the time to earn his credentials and wait for the right opportunity to make a bid for a leadership position, now legislators feel compelled to rush that process. “A study of leaders in the Arizona Legislature prior to 1992 finds that on average, members were not elected to top leadership posts until their fifth term. Compare that with today, where most individuals . . . are elected to leadership posts after just one or two terms in office.”¹⁷

Term limits, then, have taken away the leadership training ground in the Legislature and that has made the Legislature weaker, because its leaders are relatively short term. “Being an effective legislative leader is very hard. It’s not something you learn over night. Once legislative leaders have just begun to figure it out, they’re term limited.”

In the same way, term limits impact legislators’ willingness to take a controversial position because they are always looking to their next political post. And because of term limits, it is “harder to address long-term and complex issues. More time has to be devoted to basic education of members on the various issues of the day.”¹⁸

In addition, terms limits have led to short-term thinking; legislators serve in one session and by the next session are preparing for re-election, greatly discouraging strategic or long-term thinking. Some insulation is necessary for politicians to feel like they can make tough choices whose benefits may not be realized immediately. In the current environment, “there is no political will to reform.”

The Supermajority Requirement (1992)

Passed by initiative in 1992, Article 9, Section 22 of the Arizona Constitution requires that two-thirds of both chambers of the Legislature vote affirmatively for any “net increase” in revenue. Chapter 5 discusses the breadth of this measure. The effect of the supermajority requirement has been substantial. Since its passage, the only state tax increases have been passed by ballot initiative or referendum.

The supermajority rule is a “troublesome feature” of the state’s revenue code. It has “taken the Legislature out of the business of fiscal reform.” It has, in other words, allowed the Legislature to deflect fiscal decision making to the ballot. And because getting a supermajority is so difficult, the Legislature simply does not try anymore. In fact, as one taxpayer advocate of the supermajority requirement said, “Now the Legislature doesn’t even bother to propose new taxes.”¹⁹ “As long as the supermajority rule exists, it will be extremely difficult, if not impossible, to make comprehensive changes to the state’s revenue code.”

Public Campaign Financing (1998)

The Citizens Clean Elections Act was passed by the voters of Arizona in 1998 “to level the playing field when it comes to running for office.”²⁰ The Act allows candidates running for the Legislature or statewide offices the opportunity to forgo special interest money by collecting a certain number of \$5 donations. In return, the candidate receives public funding for their campaign.

“I think we had this idea that with Clean Elections we’d get great, progressive candidates; people that didn’t have special-interest money behind them—like a ‘Mr. Smith Goes to Washington,’” state Senator Jonathan Paton, a Republican from Tucson, told the *Arizona Daily Star*. “But no matter how you look at it, from the liberal perspective or the conservative, this law has not done what it was intended to do. It has lowered the quality of the Legislature; it has empowered special-interest groups; it has failed to stop money from going into politics; and it has made it more difficult to educate the public about candidates.”²¹

On top of the other institutional changes that have made comprehensive reform more difficult, public financing of campaigns has made it so that candidates do not have to raise money and then answer to constituent interests. That has had the unintended consequence of weakening the Legislature. In particular, Clean Elections has made it so the elected legislators are not necessarily close to any constituent groups. “With Clean Elections a candidate doesn’t need to court deep pockets. Instead, she has only to ask for support from those who can produce \$5 checks.”

Public financing has severed the once-traditional link between the business community and the Republican Party in the Legislature. Now that the most ideologically extreme candidates are elected without mainstream or moneyed support, the business community finds it hard to sway legislators to do “what’s good for business,” such as fund public infrastructure projects that benefit all individuals.

Clean Elections has also separated legislators from key legislative leaders. Burton Barr, for example, used to raise money for other legislators and then turn to them for support. Because it is so easy to fund a campaign now through public funding, that kind of dynamic, where legislators are beholden to those who gave/helped raise money, does not exist anymore.

In addition, Clean Elections has massively empowered special interest groups who create candidates and need only \$5 donations to do it. What may be called “arbitrary campaign finance limits” has led to bundling, where lobby organizations solicit \$5 donations for multiple candidates from the same groups. Those candidates who become legislators are beholden to the lobbyists and their clients rather than to individuals and local communities.

In other words, public campaign financing has hugely increased the power of contracted lobbyists, who have become the artificial “community” to which the legislator is beholden. Whereas a legislator used to make a decision based on a staff report explaining the bill or a fact sheet, now legislators often simply read which lobbyists are in favor and which are opposed, and vote based on where “their” lobbyist falls.

Noncompetitive Legislative Districts

By Arizona law, redistricting must respect “communities of interest” to the extent possible and comply with the federal Voting Rights Act that prevents states from diluting the strength of minority voters through gerrymandered voting districts. The purpose is for minority communities to retain the necessary critical mass to elect a national representative.

These requirements have produced unintended (and negative) consequences. Currently, 26 of Arizona’s 30 legislative districts are considered noncompetitive. In each of those 26 noncompetitive districts, candidates need not worry about winning a general election because the district is so heavily Republican or Democratic. They need only to win the Republican or Democratic primary. Because those citizens who vote in primary elections (only about 18% of the voting population) are typically the most ideologically extreme, those candidates who appeal to this subset of voters win not only the primary election but the general election as well. This has had the effect of funneling extreme legislators (on both the Republican and the Democratic sides) into the House and Senate.

Such legislators tend to not listen to a broad base of constituents because they do not have to—they only have to appeal to a small group of primary voters. As a result, few legislators are “in the middle” and few legislators are willing to compromise. The art of government, however, is the art of compromise. Simply put, leaders have no political incentive to go to the middle, where sound decisions are made.

Leadership Factors

In addition to the institutional changes that have made comprehensive reform of any kind exponentially more difficult in Arizona than it was two decades ago, there are also leadership factors that conspire to make change more difficult.

Erosion of Party Discipline

Because legislators are not beholden to any group for campaign funding, party discipline among both Republicans and Democrats has eroded. One need not look any further than the June 2009 budget battle between the Republican-controlled Legislature and the Republican governor to understand that lack of party solidarity. Legislators no longer pay heed to what the party wants, or even what is good for the party.

Decline in the Quality of Leadership

It takes more than one high-quality leader to implement comprehensive change. For example, even if the state has a strong governor, without equally strong leaders in the Legislature, the governor will likely not be able to effect change. In the bygone era of successful reform, there were leaders in both the governorship and the Legislature with “real moral courage and a willingness to take on the establishment.” Those leaders—Burton Barr, Bruce Babbitt, Alfredo Gutierrez—have become mythic figures.

That courage and willingness is largely absent among Arizona’s current leadership. Due to the institutional factors, leaders are short-term thinkers, often not collegial, and the atmosphere is divisive. Legislative decision making is rarely a function of good information. Most often, it is a function of deeply entrenched political philosophy, which is extremely difficult to move past.

Arizona's Legislature was designed as a "citizen" body. Yet, the low salary for legislators and the unusual work hours (full time for a few months) makes it difficult for many citizens to consider serving. Since 1972, a salary adjustment for elected officials has been placed on the ballot every two years. Only twice has the electorate approved an adjustment. The last adjustment was in 1998, so the current salary of \$24,000 has lost about \$7,000 of buying power since then, making it even less attractive to potential candidates.

Other states have professional legislatures; in Michigan, for example, legislators are paid a salary of \$100,000 a year and are widely considered to be among the "best and brightest" in that state. Some suggest that a professional legislature is not "in the state's cultural DNA."

"Some people think that the problem lies with Arizona's elected officials, but really it's the system." The current political system in Arizona is indeed gridlocked but it is not only because there are no Bruce Babbitts, Burton Barrs or Alfredo Gutierrezes in state government. "Anymore, the system in Arizona does not lend itself to 'big and different' ways of doing things, even when a legislator wants to do 'big and different.'" "A bad system can kill off great people." So to change the outcomes of legislative behaviors, the system must be changed.

Cultural Factors

Lack of Business Leadership in Arizona

Corporate mergers have reduced the number of large companies headquartered in Arizona. Much of the corporate leadership in Arizona today is "branch" leadership. These leaders are often "here today, gone tomorrow" with little or no stake in the long-term quality of life in Arizona. However, strong leadership from the business community is critical. Even in the best of circumstances, the governor and the Legislature cannot pass comprehensive revenue reform alone.

The "Wild West" Frontier Mentality

One of the cultural elements making reform more difficult is the nature of Arizonans as a sort of rootless, transient populace. In many respects, the state is still seen as the land of opportunity, the Wild West, where it is every man for himself. That type of culture does not typically support comprehensive tax reform. However, those cultural elements do not seem to inhibit cohesive, comprehensive policymaking at the city level in Arizona, where business and other community leaders see more clearly the direct benefit of investment, and where there are a smaller number of elected officials, often more closely tied to their constituents.

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⁹ See note 6.

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¹⁶ Ken Bennett, “Effects of Term Limits in Arizona: New Legislative Leadership,” *Spectrum: the Journal of State Government* (January 1, 2005), <http://www.allbusiness.com/public-administration/executive-legislative-other-general/360729-1.html>.

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Chapter 19

OPINIONS OF INTERVIEWEES: STRATEGIES FOR IMPLEMENTING COMPREHENSIVE REVENUE REFORM

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KEY POINTS

- Two options are available to proponents of comprehensive revenue reform. The first, working through the Legislature, is deemed to have little, if any, chance of success in the near term. The second option is a citizens' initiative.
- Regardless of the option, the lessons learned from the success or failure of previous public-sector efforts are instructive. One is that the more all parties agree that a problem exists, the more likely a solution will be crafted. Currently, a consensus does not exist that the state's revenue system is broken, despite the crisis mode of state government over the last two years due to massive budget deficits.
- Other lessons learned include getting the business community involved, finding a place where business and community leaders can agree, making a strong case to legislators and the general public, and planning an implementation strategy.
- While a citizens' initiative may be the only means of accomplishing revenue reform in the near term, and while the ideal time for an initiative may be on the horizon, systematic revenue reform may be too complex to succeed at a public vote.
- Removing some or all of the institutional barriers to legislative action likely is a precondition to successful revenue reform accomplished through the Legislature. Proponents of repealing public campaign financing will have to change the public's profoundly positive opinion about Clean Elections, even though the repeal is supported by legislators.
- In contrast, the repeal of the supermajority requirement will have to be accomplished by a citizens' initiative given the current political makeup of the Legislature.
- The repeal of term limits may be undertaken by the Legislature.
- Making more of Arizona's legislative districts competitive will be difficult given federal and state laws.

INTRODUCTION

Like Chapter 18, this chapter focuses on *the process* of revenue reform and is based on expert interviews. This chapter represents the opinions of those interviewed, but does not reflect the opinions of the author or of the Arizona Town Hall. However, not all of those interviewed agree with all of the content in this chapter.

The 24 people interviewed, who represent the ideological spectrum, generally agree that the prospect for comprehensive revenue reform coming out of the Legislature in the near term is

poor. Thus, this chapter considers two options for achieving revenue reform: a citizens' initiative and removing the barriers to legislative action.

Comprehensive revenue reform is politically very difficult, whether through the Legislature or through direct democracy. That led some of those interviewed to suggest that revenue reform be pursued in a piecemeal fashion. Some even suggested that comprehensive reform would be damaging to the state. "If you rip out the state's tax system and dramatically change it, that would cause extraordinary dislocations to the economy."

The possibility of economic dislocations is highly debatable. Further, piecemeal changes to the revenue system have been the norm in Arizona since the early 1990s. The result is the fiscal crisis of the last two years, and the lesser crisis during the previous recession. "It is easier to focus on making small changes at the margin. But then the system never gets fixed."

Moreover, piecemeal reform is contrary to the revenue system guiding principles discussed in Chapter 11, which stress the importance of viewing revenues as a system. Frequent changes to the system adversely affect predictability in particular. Predictability of revenue streams is of obvious importance to government, but predictability of costs also is critical to businesses.

Regardless of the option—citizens' initiative or legislative action—the lessons learned from the success or failure of various public-sector efforts in the last 30 years are instructive.

LESSONS LEARNED

A summary of the lessons learned is provided in Table 19.1. One lesson learned is that the more all parties agree that a problem exists, the more likely it is that a solution will be crafted. Due to massive budget deficits over the last two years, state government has been operating in crisis mode. Yet there is not a consensus that the revenue system is broken. "You need 50 plus 1% of legislators or voters to agree on reform and you simply don't have that now. The need for reform is not agreed upon by the governor, the Legislature, or the people."

Thus, the first step toward achieving comprehensive revenue reform is to generate a consensus that the state's fiscal system needs fixing. Questions like "Do we need reform?" and "Why do we need reform?" must be answered. Proponents will have to make clear the connection between the state's revenue system, cyclical budget deficits, and cyclical spending reductions for popular programs, then convince lawmakers and/or voters that the only way out of the situation is comprehensive revenue reform.

"The issue of implementing revenue reform is one of the most important topics the Town Hall could tackle. If the Town Hall says, 'The system is broken and we need to fix it,' that would be a good start."

Adopt a Long-Term Approach

Fiscal strategy needs to be long-term, not year-to-year. Leaders ideally would ask the question, "Five or ten years from now, given economic cycles and given expenditures, what

Table 19.1
Lessons Learned From Public Policy Successes and Failures

Take advantage of external pressures	A number of the state’s most comprehensive reforms have been preceded by court mandates, for example. In those cases, the time was right for major reform—external pressures and political conditions were well aligned.
The support of an activist leader is critical	Activist governors who are fiercely committed to change have been able to rally the support of legislators and other stakeholders to achieve reform.
Leverage the “all or nothing” package	Designing a proposal that the Legislature has to accept or reject in whole by an up-or-down vote has been successful in limiting the opportunity for lawmakers to haggle on pieces of a proposal.
A willingness to compromise is critical	An activist governor can be useful in forcing compromise on the part of legislators and stakeholders. Bipartisanship at the Legislature is the key to success.
Take advantage of a sense of urgency	Just as court mandates have effected change, so have circumstances that have created a groundswell among key stakeholders and/or voters.
Make the case for reform to the public	Whether the proposal will be decided by legislators or by the electorate, public support is essential. A marketing strategy that the public can rally around is a necessity.
Money matters	Usually, being well financed is necessary for success.
Build a coalition	Support from business and community groups who have the political power and financial ability to advocate for change is critical.
Make change palatable	A call for reform based on what is “good for Arizona” is often insufficient. How the reform is good for each key stakeholder must be demonstrated. Key stakeholders should not be asked to support proposals they cannot sell to their constituents; stakeholders need help in selling those ideas.
Create an implementation strategy	An implementation strategy manned by the proper people and supported by adequate resources is frequently a necessity. Sometimes, it can take a long time to achieve success.
Target the reform	Proposals that are easy to understand and highly targeted are far more likely to succeed than those proposals that offer “everything but the kitchen sink.” The public needs something they can wrap their minds around and benefits that are tangible (education in the classroom; freeways).
Use the governor’s office as a bully pulpit	Governor Babbitt concentrated on a few issues at a time and focused on overwhelming the opposition.

should the tax system look like for long-term sustainability—to protect against a worst-case \$3 billion budget shortfall?”

Yet the Legislature has a very short-term focus. It is easier and more popular to cut taxes and/or increase spending today than to plan for tomorrow. Sometimes, that is because a policymaker is looking to be re-elected; other times it is simply to satisfy a political philosophy.

Another benefit of a long-term strategic approach to Arizona’s revenues and expenditures is that it would encourage leaders to link long-term funding sources to long-term expenditures. Successful businesses, for example, would not think of operating without a long-term strategic plan. Why should it be different for state government?

In some states, in fact, it is not different. Oregon, for example, operates from a comprehensive multiyear plan called the Oregon Business Plan. “Since it was launched in 2002, the Oregon Business Plan has provided the strategic framework for Oregon’s business and elected leaders, working together, to build a stronger, more competitive state economy.”¹ There is no reason why Arizona could not develop and leverage a state business plan as well.

The development of a state business plan in Arizona would allow for a discussion about the state’s competitiveness, and give leaders the opportunity to position economic development as a key strategic objective at the Legislature. Revenue reform could follow the long-term plan and promote the competitiveness agenda.

Encourage the Business Community to Take a More Active Role

The business community in Arizona in recent years generally has not taken an active role in the state’s public affairs. Yet, “there is power in the business community. If they want to, they could bring about revenue reform.” In addition to actively supporting revenue reform, the business community could effect change by supporting candidates that are pro-business rather than anti-government.

Some note a disconnect between corporate leaders and their lobbyists. Leaders advocate change publicly at the same time that their lobbyists are at the Capitol advocating for the opposite. Both business leaders and corporate lobbyists will have to support comprehensive revenue reform if it is to happen. A good first step in this regard might be to get corporate leaders and their lobbyists in the same room to avoid an outcome like that of the Citizens Finance Review Commission (CFRC), in which CEO-group recommendations were undermined at the Legislature by corporate lobbyists.

Find a Place Where Business and Community Leaders Can Agree

Business and community leaders (including health and human services and education advocates) must work together to achieve revenue reform. Someone has to be at the wheel, driving compromise between the two groups. That leader should be someone that stakeholders either trust or fear enough to follow, someone who understands the tradeoffs that have to be made and can “crack heads and make deals.”

If much of the debate over revenue reform happens outside of the Legislature, the chances of success are raised. That is in large part what has worked for national health care reform. Differences are debated and resolved inside special meetings, think tanks, academic institutions, and among community leaders, then a reform proposal is created and brought to lawmakers.

The backroom meetings Governor Bruce Babbitt organized with key stakeholders before sending the Groundwater Management Act to the Legislature is a classic example. More generally, legislative decisions in the 1980s were largely made in subcommittee meetings. The rest of the Legislature was involved only once the subcommittee had reached a consensus and developed a proposal. A return to that kind of off-the-floor decision making may work well for revenue reform. In Montana and Oregon, for example, the Legislature is in session every other year; in between sessions members hammer out issues to develop proposals that are then saleable to the Legislature as a whole.

Make a Good Case

Whether statutory or constitutional changes are passed through the initiative process or by the Legislature, “making a good case” to the public is critical. If voters do not understand a proposal, they will not support it and if presented the option on the ballot, they will vote no rather than yes. “It is classic political science: the inertia effect.”

Scenario development can be an extremely effective tool for informing voters about the consequences of a certain action or, perhaps more appropriately, of inaction. Scenario development paints a picture for voters of what their lives would be like if the measure is passed and if it fails. If the failure picture is scary enough, voters will likely help to drive change. It is akin to the “outrageous anecdotes” that tax reform supporters used to rally public support for the 1986 Federal Tax Act. Those scenarios or anecdotes, of course, must be backed by real data that bear out the doom-and-gloom scenario.

An important factor in getting public support is honesty. “Don’t dress it up. If the issue is that taxes need to be raised because the state needs more money, tell the voters that. Hiding behind language like ‘temporary tax increase,’ if that’s not what you’re really talking about, only hurts the effort.”

The messages to the public must be as simple and concise as possible. Often, tax policy experts, economists, and others who advocate for tax reform are “nuanced”—they need someone to take their analysis and make it accessible and motivating for legislators and voters. Successful reform proposals can be compressed onto bumper stickers and sound bites. “If you’re explaining, you’re losing.”

Ballot initiatives are susceptible to being overly complex and comprehensive revenue reform will be complex. “Complexity is a huge problem in selling revenue reform to voters.” To succeed on the ballot, then, an initiative would have to be written in a way that was both understandable and generated an emotional response from voters.

Convincing voters of the importance of tax reform is difficult not only because of its complexity but also because the notion of “tax reform” is so abstract. That is why the revenue-related reforms that have been successful have been highly targeted (the sales tax increase for education, for example, or the 1980 property tax proposition). “It’s very hard to motivate people to support ‘better tax structure’ reform. Much more effective is targeted reform that speaks directly to a certain issue, like education funding or property taxes.”

Making a case to the public for revenue reform will be more difficult if what reformers want to do runs counter to public opinion:

- Most tax policy experts think that the sales tax base should be broadened (to include services) and rates should be lowered, but it is not clear that the public agrees.
- Tax policy experts say that the state’s business property and business income taxes are too high, but to lower business tax rates in the context of a revenue-neutral reform would require higher taxes on individuals, which the public likely would not support.
- Some tax experts favor a huge savings account (rainy-day fund), but that requires asking politicians to leave the money alone. “Maintaining that kind of political discipline defies the Legislature’s DNA.”

Both Fiscal 2000 and the CFRC failed in part because the groups’ recommendations ran counter to public sentiment. “Governor Napolitano was never willing to press for fundamental revenue reform based on the CFRC recommendations because those recommendations tilted against public sentiment.”

If the right thing to do from the economic perspective runs counter to what the public wants to do, then reform will be extremely difficult. Here it is instructive to look at the federal tax reform passed in 1986. As Jeffrey Birnbaum and Alan Murray tell it, lawmakers, as representatives of the people, were not particularly motivated to reform the federal tax system. Yet a few tax experts were able to convince key policymakers to take up the tax reform banner. “One of the remarkable lessons of tax reform—one that should encourage attempts to apply the lessons elsewhere—is that you don’t need many reformers to effect reform. The key players were not, for the most part, men who had lost sleep over the inequities of the tax code.”²

Plan an Implementation Strategy

An implementation strategy typically has not been a part of prior revenue reform efforts. Excellent reports from Fiscal 2000 and the CFRC died because of this. While saying *what* is often easier than saying *how*, a strategy to implement recommendations through statutory and constitutional enactments needs to be devised.

Some lessons can be learned from other states’ experiences. In Michigan, for example, after a very deep recession between 1973 and 1975, the Legislature and the governor appointed a broad task force comprised of business, labor, political, and citizen leaders, headed by a corporate executive. Once that task force completed its study, it handed its recommendations off to a new implementation team, which had some holdovers from the study group, but was primarily composed of the kind of people who could “knock heads and get things done.”

Key success factors in planning an implementation strategy include:

- The implementation team should have the staff, resources, and government support to drive home the study group’s recommendations.
- A scorecard to measure the implementation team’s progress should be kept.
- The implementation team must have the backing of business leadership, political leadership, and grassroots community support, as did successful ballot initiatives such as the sales tax to benefit education.

CITIZENS’ INITIATIVE

Because of the issues discussed in Chapter 18, many conclude that the only path to reform is going around the Legislature, by pursuing a citizens’ initiative. “Going to the ballot with a comprehensive revenue reform proposal often makes more sense than trying to get something passed in the Legislature.”

In some cases, citizens’ initiatives succeed by scaring the Legislature into action (that was true for the 1980 property tax proposition, for example). A hybrid strategy that has proven effective involves double-tracking the development of a ballot initiative with a bipartisan legislative package. The implementation team can use the ballot initiative to force the Legislature to act: “either work with us or we’ll go over your head and put the reform on the ballot.”

However, some suggest that ballot initiatives are fundamentally bad for the state. “You would never run a company by ballot initiative—why would you run a state that way? If we’re going to have a representative democracy, then make that representative democracy work. Mixing representative and direct democracy hinders the state’s ability to drastically change.”

Removing the institutional barriers to reform may be necessary to re-establish effective representative government in Arizona. That, however, likely is a long-term project, as discussed later in this chapter.

Thus, a citizens’ initiative may be the only option to realizing comprehensive revenue reform in the near term. Direct democracy may be a “crude tool” but it is currently the only way the state government really functions. A large majority of the successful reforms, revenue and otherwise, in the last 15-to-20 years were either referred to the ballot by the Legislature or were put there through citizens’ initiatives.

If there is ever a time to put comprehensive revenue reform on the ballot, experts agree that time is now. “The full impact of the state’s fiscal woes has not hit home yet. But it will soon, and that is the critical time to take comprehensive revenue reform to the people.”

However, some suggest that systematic revenue reform may be too complex to succeed at the ballot. The last three state trust land propositions failed, perhaps in part due to their complexity.

To successfully “sell” comprehensive reform to the public as a ballot proposition, proponents need to:

- Have a great message. Present a reasonable argument in simple terms that people can rally around; synthesize that message into 30-second sound bites.
- Demonstrate to the public that the reform would be fair and balanced.
- Educate the public with detailed impact analyses to show the tangible benefits of the reform.
- Gather a critical mass of support from major stakeholders (legislators from each party, the business community, the education community, community action groups, and similar organizations).
- Engage a powerful, credible leader who understands tax policy and is willing to go to bat for it.
- Bring the ground game. In the 2008 presidential election, Barack Obama proved the incredible effectiveness of organization and motivation on the ground.
- Find a credible enemy. One reason for the success of the 2008 predatory lending ballot initiative was that the “little guys” backing the proposition made the big payday loan industry the enemy; that proved to be a message the public could rally around.
- Raise money; to succeed, the initiative must be extremely well financed.

LEGISLATIVE ACTION

Removing some or all of the institutional barriers, which are summarized in Table 19.2, likely is a precondition to successful revenue reform accomplished through the Legislature. That alone will not be sufficient. In addition to applying the lessons learned, proponents of tax reform need to have a thorough understanding of the Legislature.

Remove Institutional Barriers

As discussed in Chapter 18, several institutional barriers since the early 1990s have made it difficult for any type of major legislative initiative to be successful. This section examines the possibilities of removing those barriers so that state government can function more like it did in the past.

Repeal Public Campaign Financing

Early this year, Senator Jonathon Paton, a Republican from Tucson, introduced a referendum bill “that would ask voters to amend the state Constitution so that no taxpayer funds could be spent on candidates or campaigns for statewide offices or the Legislature.”³

But while some legislators are interested in repealing public campaign financing, that is not likely to be a measure that fares well with the voters. “According to a January 2008 Clean Elections Survey, 70 percent of Arizonans familiar with the program had a ‘favorable’ or ‘very favorable’ impression of Clean Elections. In addition, 81 percent of those people said the system was ‘somewhat important’ or ‘very important’ to voters in Arizona.”⁴ Thus, to repeal public campaign financing in Arizona, proponents will have to change the public’s profoundly positive opinion about Clean Elections.

Table 19.2
Barriers to Comprehensive Revenue Reform

	Barrier	Consequences
Institutional barriers	Term limits	<ul style="list-style-type: none"> Increases the power of legislative staffers and lobbyists Reduces the level of institutional knowledge among legislators Encourages rapid movement into leadership positions Makes it harder to address long-term and complex issues Leads to short-term thinking
	Noncompetitive legislative districts	<ul style="list-style-type: none"> Funnels extreme legislators (on both the Republican and the Democratic sides) into the House and Senate Causes legislators to only have to appeal to a small group of primary voters rather than listen to a broad base of constituents Reduces the number of legislators in the middle who are willing to compromise
	Public campaign financing (“Clean Elections”)	<ul style="list-style-type: none"> Weakens the Legislature because candidates do not have to raise money and then answer to constituent interests Separates legislators from the business community, and from key legislative leaders as well Empowers special interest groups who create candidates Increases the power of contracted lobbyists
	The supermajority requirement	<ul style="list-style-type: none"> Makes it extremely difficult, if not impossible, to make comprehensive changes to the state’s revenue code, taking the Legislature out of the business of fiscal reform Causes the Legislature to deflect fiscal decision making to the ballot
Leadership barriers	Erosion of party discipline	<ul style="list-style-type: none"> Contributes to legislators no longer paying heed to what the party wants Makes it more difficult for legislative leaders to corral party members into a consensus or coalition
	Low and falling legislative salaries	<ul style="list-style-type: none"> Makes it difficult to attract candidates for office
Cultural barriers	Lack of business leadership	<ul style="list-style-type: none"> Reduces the role of a group that formerly took an active part in policy decisions
	“Wild West” frontier mentality	<ul style="list-style-type: none"> Causes citizens to be suspicious of government and less willing to compromise for the good of all

Repeal the Supermajority Requirement

There is consensus that Arizona's supermajority requirement to pass a net revenue increase has made tax increase proposals (which could be a part of comprehensive revenue reform) dead on arrival. Many legislators who are ideologically committed to low taxes, no matter the situation, are strong supporters of the supermajority requirement. So it is not likely that legislators would vote to repeal the supermajority requirement, or even vote to put a repeal measure on the ballot. If the law is to change, then, it will have to be accomplished by a citizen-driven ballot initiative.

Make Districts More Competitive

Given the constraints imposed by federal and state laws, it is not feasible to make all legislative districts competitive, but it may be possible to increase the number of competitive districts. This would help to restore moderation within the Legislature. Some experts, however, believe that only about six districts could be competitive given the constraints imposed by the federal requirements.

Increased competitiveness would have the effect of pushing viable candidates to the middle. That could make the environment at the Capitol more conducive to the passage of comprehensive revenue reform. "The underlying premise of a push to more competitive legislative districts is that the state needs more moderate legislators who are willing to compromise to get reform."

The creation of legislative and congressional districts is conducted every 10 years, shortly after the results of the decennial census become available. Through the 1990s, district lines were redrawn by the Legislature. The party that controlled the Legislature at the time of redistricting crafted districts favorable to their re-election, districts that would remain in force for 10 years. Hoping to create a system that resulted in more competitive districts, the public passed Proposition 106 in November 2000, which created the Independent Redistricting Commission. The commission is composed of two Democrats, two Republicans, and one Independent.

The commission is legally required "to the extent practicable" to favor competitive districts, but only "where to do so would create no significant detriment to the other goals." According to Steve Lynn, chairman of the commission, "Communities of interest and compliance with the Voting Rights Act are the enemy of competitive districts. I don't mean that pejoratively in terms of the first two; I think they're noble goals. It's just that they counterbalance one another. So, the more competitive you wish to be, the less you'll be able to do the other two."⁵

Thus, the creation of the commission did not result in more competitive districts. Some suggest changing state law to make the creation of competitive districts a prime goal of the Commission. Other experts suggest returning the role of redistricting to the Legislature.

Repeal Term Limits

According to former state Senator Jake Flake, "along with many of my colleagues and members of the public, I have been arguing for years that term limits should be repealed.

They are undemocratic, unconstitutional (I believe), and prevent effective representation of our constituents' interests. Many states that embraced term limits in the 1990s have since seen the folly of their choice and repealed the measure. Others, like Arizona, have not yet made a serious effort to overturn what is still a relatively popular reform."⁶

Some of those interviewed suggest only that term limits in the Legislature be repealed. "Sen. Carolyn Allen said she intends to run a bill in 2010 to ask voters to repeal the term-limits law. It can be done, she said. 'They did it in Idaho,' she said, adding she has conferred with the Idaho Republicans, who successfully fought to repeal term limits in 2002 . . . even overriding the GOP governor's veto."⁷

Others suggest that term limits not only be repealed but that legislative terms be extended to six years, with staggered elections as in the U.S. Senate. Others support more drastic measures, including replacing the Legislature with a unicameral, nonpartisan body, akin to city councils. "A bicameral legislature in a state is pointless and makes it harder to pass legislation."

A unicameral legislature might limit the number of bills that are lost in committee and the incidence of legislators deflecting their responsibility to the ballot. In addition, fewer legislative seats might lead to more competition for those seats. "If there were only 60 seats in the whole legislature, then that would increase the visibility and prestige of each seat." That, perhaps combined with higher salaries, could attract professional legislators.

Understand How the Legislature Really Works

Removing the institutional barriers to reform and applying lessons learned from past successes and failures will be important steps toward achieving comprehensive revenue reform for Arizona. But because much of a reform's success and failure is rooted in legislative process, understanding how the Legislature works is a critical step in achieving success.

The Legislature is typically reactive; it responds to issues that are backed by sufficient public pressure to drive change (the exception, of course, is when the Legislature leads, but that has been rare). So legislative leadership is really effective followership.

Within the Legislature, leaders are beholden to their caucuses. Legislative leadership is about forming a consensus and moving forward. The oft-quoted rule in the Arizona Legislature is "16 and 31"—that is, one needs 16 votes in the Senate and 31 votes in the House to have the simple majority required to pass most bills. "Decisions lie at the center of those 16 or 31 people—in their common agreement."

A legislative leader—even one as influential as Burton Barr, for instance—cannot simply "make something so;" legislators are autonomous decision makers. Legislative leaders, then, have limited authority but do have the power to influence. Wielding that influence takes both skill and experience.

Leaders' power in the Legislature comes into play in large part in setting the legislative agenda. Typically, fiscal decisions are made by first deciding how far the Legislature can cut spending before constituents push back and then determining how much to raise taxes. "Doing spending cuts first builds strength for a tax increase. It doesn't work vice versa."

There is a connection in voters' minds between spending and revenue. The first step in successful revenue reform is to evaluate expenditures, making changes if necessary. "Go to voters with a record of prudence and it's easier to make the case for a tax increase." Without that concerted effort to reform both expenditures and revenue, the only changes that can be made are incremental rather than comprehensive.

Legislators are beholden to their constituents (defined as those who vote for the candidate, not those citizens living in the district); lawmakers have to defend every decision they make to their constituents. Therefore, any group that is looking for legislative action must articulate the action so that the legislator can understand it and so that the legislator can communicate the benefits of the action to his constituents.

The process of advocating for change in the Legislature is not an appeal to the authority of a report or study but is an educational process to build consensus toward action and, most importantly, ensure that the advocates' recommendations are responsive to what the legislators' constituents want. For that reason, dramatic action like comprehensive revenue reform is often more easily undertaken in times of crisis; voters are susceptible to argument, they can see and feel the problem and are ready for the solution.

The most effective governors position public opinion to in turn influence the Legislature; it is a tactic that has proven far more effective than simply going directly to the Legislature. (Governor Jan Brewer has worked to appeal to the public to exert pressure on the Legislature.)

If community and business leaders and tax experts believe that comprehensive revenue reform is necessary to fix the state's fiscal problems, their most important task is to convince the public and thereby the Legislature. The overall failure of Fiscal 2000 and the CFRC to generate comprehensive revenue reform is due to the fact that there was no public, and thereby no legislative, groundswell to compel action.

When approached by advocates of change, legislators will ask, "Why do I care?" If advocates can articulate the benefits of action for the legislator's constituents (and, in turn, the legislator) then it is much more likely the legislator will support their request.

Legislators are representative of their constituents, of those who voted them into office and will vote to keep them there (or not). Thus, what might seem to be ideological behavior on the part of legislators is actually quite rational given the people who vote to put, and keep, those legislators in office. Therefore, it is not the people in the Legislature that are the problem, it is the system. "The process is what it is. Changing the process is futile—changing the system and its institutional arrangements (like term limits or public financing) that affect the process is what needs to be done."

Design the Proposal as an “All or Nothing” Package for the Legislature

When the U.S. Congress was faced with the task of closing a number of military bases across the country, leaders knew deciding which to close via the normal decision-making processes would be impossible. So Congress created the Defense Base Closure and Realignment Commission to recommend which bases should be closed. Then Congress had to vote up or down on the entire set of recommendations (without picking and choosing which base closure recommendations to accept).

In essence, Congress delegated authority to an expert group. The Arizona Legislature took similar action when faced with the Supreme Court ruling regarding water rights, delegating to a carefully selected representative group the authority to sort out a highly technical and complex issue and to craft legislation that the Legislature would then agree to in whole or reject.

Given the technical and complex issues regarding revenue reform, a rationale could be made to follow a similar strategy. The Legislature would have to agree to this course of action at the beginning, so it is unclear if this is a viable option.

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¹ Oregon Business Plan, <http://www.oregonbusinessplan.org>.

² Jeffrey Birnbaum and Alan Murray, *Showdown at Gucci Gulch: Lawmakers, Lobbyists, and the Unlikely Triumph of Tax Reform* (New York: Random House, 1987).

³ Martin Rosales, “Elections Remain Messy,” *Arizona Daily Star* (February 22, 2009), <http://www.azstarnet.com/allheadlines/280943>.

⁴ See note 3.

⁵ “Q&A: Steve Lynn,” *Policy Today* (November 2, 2005), http://www.policytoday.com/index.php?option=com_content&task=view&id=50&Itemid=148.

⁶ Jake Flake, “Effects of Term Limits in Arizona: Irreparable Damages,” *Spectrum: the Journal of State Government* (January 1, 2005), <http://www.allbusiness.com/public-administration/executive-legislative-other-general/360727-1.html>.

⁷ Casey Newton and Mary Jo Pitzl, “Political Insider: Sen. Allen on Crusade to Repeal Term Limits,” *Arizona Republic* (May 31, 2009), <http://www.azcentral.com/arizonarepublic/local/articles/2009/05/31/20090531politics-insider0531.html>.

Appendix 1

INTERVIEWEES FOR CHAPTERS 18 AND 19

William W. Beach, Director, Center for Data Analysis, Heritage Foundation

David Berman, Senior Research Fellow, Morrison Institute for Public Policy, Arizona State University

Peter Burns, Principal, Burns and Associates, a Health Policy Firm; former Budget Director, State of Arizona

Jeff Chapman, Professor of Applied Public Finance, School of Public Affairs, Arizona State University

Lattie Coor, Chairman and CEO, Center for the Future of Arizona; former President, Arizona State University

George Cunningham, Principal, Cunningham Consulting Group; former Deputy Chief of Staff for Finance and Budget to Governor Janet Napolitano

Ted Ferris, Principal Member, Quadpro Consulting; former Executive Director, Joint Legislative Budget Committee

Thomas Franz, President and CEO, Greater Phoenix Leadership; former Vice President and General Manager, Intel Corporation

Grady Gammage, Senior Research Fellow, Morrison Institute for Public Policy, Arizona State University; Attorney, Gammage & Burnham

Michael M. Grant, Attorney, Gallagher & Kennedy; former host of Horizon

Peter Hayes, Manager of Public Affairs, SRP; former Chief of Staff to Governor Fife Symington

J. Elliott Hibbs, Executive Director, First Things First; former Director, Arizona Department of Revenue

Matthew Ladner, Vice President of Research, Goldwater Institute

Alan Maguire, President and Principal Economist, The Maguire Company

Kevin McCarthy, President, Arizona Tax Research Association

Rob Melnick, Executive Dean, Global Institute of Sustainability, Arizona State University; former Director, Morrison Institute for Public Policy, Arizona State University

Dana Naimark, President and Chief Executive Officer of Children's Action Alliance

Janice Palmer, Director of Governmental Relations for the Arizona School Boards Association

Jack Pfister, former General Manager, Salt River Project

Bob Robb, Editorial Columnist, Arizona Republic

Tim Schmaltz, CEO, Protecting Arizona's Family Coalition

Martin Shultz, Vice President of Government Affairs, Pinnacle West Capital Corporation

Randie Stein, Vice President, Stone & Youngberg; former analyst, Arizona Senate Finance Committee

Nancy Welch, Associate Director, Morrison Institute for Public Policy, Arizona State University

Appendix 2

DATA AND DATA MEASURES USED IN THIS REPORT

Data

Two primary sources of government revenue data for Arizona that are discussed throughout this report are described below. Each source presents data using the state's fiscal year, which runs from July 1 through June 30. In addition, several specialized sources of data are presented in one or more chapters. Some of these specialized sources present little detail; for example, the Tax Foundation provides only an overall measure of tax burden.

Arizona Joint Legislative Budget Committee

The Arizona Joint Legislative Budget Committee (JLBC) provides state government revenue and expenditure data by fiscal year.¹ Revenue data are available from 1971 through 2009. The focus is on the state's general fund, which is limited to revenues raised by state government itself and over which the Legislature has some discretion. It is the general fund that has been in the news during the last two years because of its large deficit.

Because accounting systems vary from state, it is not possible to directly compare the JLBC's state government data to that of other states. The JLBC data are examined particularly in Chapter 7.

Census Bureau Government Finance Series

The primary source of data on public-sector revenues and expenditures across the United States is the state and local government finance series compiled by the U.S. Department of Commerce, Census Bureau.² Using a consistent accounting system for all states, the Census Bureau presents fiscal year revenue and expenditure figures for state governments, for the combined total of all local governments by state, and for the combined total of all state and local governments by state. The Census Bureau creates a national total by aggregating the data across all state.

The combined state and local government data are used most often and are the focus in this report. The level of government levying taxes and fees and having responsibility for funding programs varies from state to state. Over time, within any state, these responsibilities may shift between state and local governments. Thus, neither state nor local government finance data can be meaningfully compared across states.

The Census Bureau's combined state and local government finance data run from fiscal year 1964 through fiscal year 2006, though data for 2001 and 2003 are limited to national totals. In most years, the local government data are derived from a survey of local governments, but in years ending in '2' and '7' a census of governments is conducted.

Most of the detail reported by the Census Bureau is for "general" revenue and expenditures, but information also is provided for utility, liquor store, and insurance trust finances. For

Arizona state government, the Census Bureau’s definition of “general” is much broader than the general fund of the Arizona Joint Legislative Budget Committee. Like the state government, local governments utilize special funds as well as a general fund. The revenue reported by the Census Bureau consists of state and local government tax collections, nontax revenue (such as user fees) of state and local governments, and intergovernmental transfers from the federal government to state and local governments.

The Census Bureau’s combined state and local government data are examined particularly in Chapter 9, with Arizona compared to the national average. In Chapter 14, Arizona is ranked among the 51 “states” (including the District of Columbia). In addition, Arizona is compared to a subset of western states (California, Colorado, Nevada, New Mexico, Oregon, Texas, Utah, and Washington).

The Census Bureau’s government finance series is a rich source of data regarding revenues and expenditures. Its major shortcoming is the lag in publishing the figures. Another weakness of the Census Bureau data is common to that of nearly all sources: revenue paid by businesses cannot be separated from that paid by individuals (except that the corporate and individual income taxes have been separated by the Census Bureau in recent years). Similarly, taxes and fees paid by tourists, business travelers, and seasonal residents cannot be isolated from those paid by residents. Thus, tax burdens calculated from the Census Bureau data substantially overstate the direct state and local government taxes paid by the average resident to his/her home state.

Data Measures

In order to compare the government finance data of states of widely varying sizes, and to compare data in one state over time as the population changes, the government finance data must be adjusted. Two measures typically are employed to adjust for size differences in revenue: per capita (per person) and per \$1,000 of personal income. If the per capita measure is used to look at data over time, it must be adjusted for inflation.³

In this report, the per capita figures are calculated using the average of the beginning and end of year population; population estimates are produced just once a year, as of July 1. Personal income and inflation, as measured by the gross domestic product implicit price deflator, are available quarterly. To match to the fiscal year, quarterly personal income and inflation from the third quarter of one calendar year through the second quarter of the next year was averaged.

Per Capita

The per capita measure is simple and straightforward—for example, total taxes divided by population—but is criticized for not considering the concept of ability to pay. For example, the same amount of per capita taxes in a state with low incomes will be more of a burden to taxpayers than in a state in which residents have higher incomes. From one perspective, acknowledging differences in income levels (the ability to pay) across states is important. From another perspective, however, a highly progressive tax system can collect average per capita revenue in a state with low incomes without unduly burdening those with low incomes.

Moreover, states with low incomes have greater demands for their public services. Limiting tax collections (and therefore expenditures) to the average ability to pay could compromise the capacity of the state to address income and related issues, helping to perpetuate those problems. Similarly, limiting the amount of spending in a poor state will equate to a lower quality and/or lesser quantity of infrastructure and other government services in that state relative to other states. In turn, subpar infrastructure and government services will limit the poor state's economic development, perpetuating its status as a poor state.

A drawback to comparing per capita measures across states is that the cost of living varies by state. Research has shown that a meld of unadjusted and cost-of-living-adjusted data provides the best comparison across states. However, a state-level index of living costs is not regularly produced. Various efforts to produce cost-of-living indexes have consistently shown Arizona's living costs to be quite close to the national average. Thus, adjusting for the cost of living has little impact on Arizona's comparison to the national average, but the ranking among states can be different after adjusting for living costs.

While the per capita measure has limitations, so do the alternative methods of comparing government finance data over time and across states. The per capita measure as well as the income measure (described below) is presented in this report to compare government revenue figures *for a given year*. Per capita analyses *over time* are *not* recommended. Inflation-adjusted per capita incomes in the United States rise over time due to productivity gains by an average of close to 2% per year. In an increasingly affluent society, government tax collections per capita can increase without the tax burden increasing. Thus, over time it is important to consider changes in income when analyzing government finance data.

Moreover, a growing and changing economy creates additional costs to the public sector and additional demands for public services, requiring the growth of public revenue to keep pace with economic growth. For example, government agencies and schools have expended substantial monies to acquire computer hardware and software to keep pace with the technological changes.

Relative to Personal Income

The most common way to account for income differences across states and across time is to divide the government revenue or expenditure figures by personal income, usually expressing the result per \$1,000 of personal income. Use of this measure simultaneously adjusts for population growth and inflation. The same sort of adjustment can be made using other economic measures, such as gross national product by state. Personal income, however, is the most promptly released and is available on a quarterly as well as annual basis. Personal income is used in Arizona statutes and in the Constitution for purposes such as the calculation of the appropriation limitation and the operation of the budget stabilization fund.

While personal income is a reasonable measure of economic growth, it is a poor indicator of ability to pay. Personal income is defined broadly and includes nonmonetary income, such as pensions paid by an employer, contributions paid by both the employer and the employee for government social insurance, and the imputed rent received by homeowners. Income received by entities other than individuals, such as businesses, also is included. Since these

sources of income are not available to households to apply to tax payments, personal income produces a distorted indicator of ability to pay.

In contrast, a measure such as household income includes only the money income actually received. Conceptually, money income would be much better as an adjustment to reflect ability to pay, but reliable money income estimates are not available annually by state.

In Arizona, the difference between the personal income and household income measures—which have been limited to decennial census data—has been substantial. In 1999, per capita income from the decennial census was 6 percent less than the national average, while per capita personal income was 15 percent less than the national average. The difference between these two measures was greater in Arizona than in any other state.

This large difference between the two income measures relative to the national average suggests either that the BEA is underestimating nonmoney income in Arizona in those components for which state-specific data do not exist, or that income other than household money income is extremely low in Arizona. In either case, including nonmoney income results in the understatement of the ability of Arizonans to pay taxes. Thus, personal income does not provide an accurate measure of the ability to pay in Arizona.

Despite these limitations, the personal income measure is used in this report along with the per capita measure to compare government revenue and expenditure figures *for a given year*. When comparing government revenue and expenditures *over time*, it is important to consider gains in real per person income. Thus, despite its shortcomings, the personal income measure is preferred to the per capita measure when comparing data over time.

Other Measures

The tax burden is simply the amount of taxes paid relative to income. The Tax Foundation annually produces such a measure, using alternative definitions of taxes paid from those used by the Census Bureau. The income measure also is different from personal income. The Tax Foundation's measure is reported in Chapters 9 and 14.

A very different measure, specifically used to assess tax burden, is to calculate the amount of taxes that would be paid by a hypothetical household or business. It is of particular value to individuals and businesses making migration decisions. While the results can provide high-quality information for the hypothetical household or business, the findings should not be generalized to other households or businesses. Since this method is very labor intensive, few studies employ this approach and those that do limit their analyses to a small number of hypothetical businesses or households. The government of the District of Columbia produces such a study annually; it is discussed in Chapters 9 and 14.

¹ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm>.

² U.S. Department of Commerce, Census Bureau, <http://www.census.gov/govs/www/estimate.html>.

³ Estimates of personal income, inflation, and population are available from the U.S. Department of Commerce, Bureau of Economic Analysis, <http://www.bea.gov/>.

Appendix 3

GLOSSARY

A

- Ability to pay:** the principle that taxes should vary according to an individual’s level of wealth or income; also the capacity to pay for a tax; contrast to “benefits principle”
- Accountability:** a fiscal system guiding principle that refers to the linking of revenues and expenditures—changes in revenues and expenditures should be matched
- Adjusted gross income (AGI):** total taxable income less allowable deductions, as defined by the federal income tax code
- Appropriation:** a legislative act authorizing the expenditure of a designated amount of public funds for a specific purpose
- Arizona Health Care Cost Containment System (AHCCCS):** pronounced “access,” Arizona’s alternative to Medicaid
- Arizona Joint Committee on Capital Review (JCCR):** legislative committee and staff that is responsible for the oversight of capital projects
- Arizona Joint Legislative Budget Committee (JLBC):** legislative committee and staff that is responsible for oversight of the state budget
- Arizona personal income (AZPI):** as used in the calculation of transfers to and from the state’s budget stabilization fund, defined as personal income less transfer payments
- Assessment ratio:** used in the calculation of the property tax liability, it is multiplied by the limited property value to determine the net assessed valuation; the assessment ratio varies by class of property, with the residential ratio 10%

B

- Benefits principle:** taxing businesses and individuals to pay for the public services they use—those who benefit more from government expenditures should pay more taxes; contrast to “ability to pay”
- Bond:** a debt to be paid back in a defined period of time at a specified interest rate
- Budget:** an estimation of the revenue and expenses over a specified future period of time
- Budget deficit:** an excess of expenditures over revenues; may result from a structural deficit and/or a cyclical deficit
- Budget stabilization fund (BSF):** popularly called the “rainy-day fund,” a fiscal device used by state governments to store extra revenues during economic expansions for use in economic downturns when revenues are inadequate to meet public demands
- Budget surplus:** the amount by which revenue exceeds spending over a particular period of time
- Business climate:** general economic environment: how state, regional, and local policies, relationships and local communities support business development
- Business taxes:** taxes imposed on the purchase, ownership, or use of inputs in a productive activity that are levied on businesses

C

Capital: financial assets or the financial value of assets such as cash, factories, machinery, and equipment

Capital gain: an increase in the value of a capital asset (particularly an investment or real estate) that gives it a higher worth than the purchase price

Capital outlay (or expenditure): funds spent for the acquisition of a long-term asset, such as a building or a highway

Citizens Finance Review Commission (CFRC): a study of the state's revenue system in 2003

Clean Elections: an act passed by Arizona voters in 1998 to reform campaign financing

Competitiveness: one of the revenue system guiding principles: revenue policy should promote economic vitality and prosperity by equitably dividing the revenue burden between businesses and individuals

Constitution: fundamental laws and principles that prescribe the nature, functions, and limits of a government

Contingency fund: money set aside to cover unexpected conditions

Corrections: the various methods, such as incarceration, parole, and probation, by which society deals with convicted offenders

Countercyclical: cyclical movements contrary to those of the economic cycle

Current charges: term used by the U.S. Census Bureau in place of "user fees"

Cycle: an interval of time during which a sequence of events occurs; see "economic cycle"

Cyclical deficit: a temporary deficit that occurs during weak economic conditions resulting mostly from a cyclical reduction in revenues, though a countercyclical demand for public services also may contribute; contrast to "structural deficit"

D

Debt: an amount of money borrowed and owed; part of a fiscal system

Debt finance: the acquisition of funds by borrowing, typically used to pay for the construction or purchase of long-lasting assets

E

Economic cycle: a sequence of economic activity over a span of a few to several years typically characterized by recession, recovery, growth (expansion), and decline

Economic development: the process and policies by which a region improves the economic and social well-being of its people

Economic Estimates Commission (EEC): legislatively created to determine appropriations limits and to perform other functions

Efficiency: one of the revenue system guiding principles: revenue policy should have minimal impacts on economic behavior by using a broad tax base with low tax rates

Excise tax: selective sales taxes, such as the tax on motor vehicle fuel

Exportability: one of the revenue system guiding principles: nonresidents such as tourists should contribute to the revenues collected by governments

F

Fiscal: of or relating to government expenditures, revenues, and debt

Fiscal 2000: common name used for the Arizona Joint Select Committee on State Revenues and Expenditures, which met in 1989

Fiscal year: July 1 through June 30 for most governments

Flat tax: typically applied to the income tax, a single tax rate; contrast to “graduated tax”

Full cash value: synonymous with market value; contrast to “limited property value”

G

General fund: the primary or catchall fund of a government, including all assets and liabilities that are not assigned to a special purpose fund

General revenue: as defined by the U.S. Census Bureau, taxes, user fees, and other income to all funds except utility, liquor store, and insurance trust

Government: the organization through which a political unit exercises authority and performs functions

Graduated tax: a tax in which the rate applied rises with income; contrast to “flat tax”

Gross domestic product (GDP): the market value of goods and services produced by labor and property in the United States, regardless of nationality

Gross receipts tax: a tax on the total gross revenues of a company, regardless of their source, often paid in lieu of corporate income or property taxes; examples include taxes on insurance premiums and public utilities

H

Health and welfare: a category of government expenditures that consists of health programs (including Medicaid) and various assistance programs, such as nutrition assistance (formerly food stamps)

Highway user revenue fund (HURF): one of the many state government funds other than the general fund, it receives funding from motor vehicle fuel taxes and various other transportation-related taxes and fees, with expenditures limited to specified transportation-related purposes

Homeowner’s rebate: reduces the school district primary property tax levy of owner-occupied residential properties; the school districts are reimbursed for the amount of the rebate by the state

Horizontal equity: equal treatment of people or businesses of equal means, one of the revenue system guiding principles

I

Impact fee: implemented by a local government on a new development to help fund and pay for the construction or needed expansion of offsite capital improvements, such as roads and sewer systems

Income tax: tax levied on the gross income of individuals or on the net income of corporations and businesses

Inflation: an increase in the general level of prices, typically measured by the consumer price index or the gross domestic product implicit price deflator; the latter is used in this report

Infrastructure: the basic facilities, services, and installations needed for the functioning of a community, such as transportation and communications systems, power plants, and schools

In-lieu tax: payment made in place of paying a tax, for example by public utilities

Insurance premium tax: imposed on net insurance premiums received by insurance companies for risks that exist within the state

L

Laffer curve: a relationship between tax rates and tax receipts indicating that rates above a certain level produce less revenue because they discourage taxable endeavors, and vice versa

License tax: a fee paid to the government for the privilege of being licensed to do something, such as sell liquor

Limited property value: used in the calculation of the property tax due, it is multiplied by the assessment ratio to determine net assessed valuation; it is limited in the rate at which it can increase

Local government: counties, incorporated cities and towns, school districts, and special districts

Luxury tax: a selective sales tax applied to tobacco products, liquor, or gambling

M

Market failure: when the production or use of goods and services by the private sector is not efficient, resulting, for instance, in too much pollution or too little education from a societal perspective

Medicaid: federal and state government program for paying certain medical expenses of persons of low income; called AHCCCS in Arizona

Medicare: federal government program of hospitalization insurance and voluntary medical insurance for persons aged 65 and over and for certain disabled persons under 65

Multiplier: the size of “carry-through effects” resulting from increased spending

Municipality: an incorporated city or town

N

Net assessed valuation: determined by multiplying the limited property value by the assessment ratio, it in turn is multiplied by the tax rate to determine the property tax liability

Neutrality: one of the revenue system guiding principles: differential treatment of similar economic activities should be minimized by limiting the number of tax credits and exemptions

Nominal: not adjusted for inflation; contrast to “real”

O

Ongoing revenue: as applied to the general fund, excludes any carry-forward amount from the prior year and any transfers from other funds

Own-source revenue: revenue realized by a government from its own tax levies, user fees, and other sources; excludes revenue transferred to it from another government

P

Per capita: per person

Per capita personal income: personal income divided by the number of residents

Per \$1,000 of personal income: revenue (or another measure) divided by personal income

Personal income: a measure of income produced by the U.S. Department of Commerce, it includes income received by persons from all sources: from participation in production as well as from government and business transfer payments

Personal property: furniture, equipment, and tools used for commercial purposes

Predictability: one of the revenue system guiding principles: taxpayers and policymakers both benefit from a revenue system that is changed infrequently

Primary property tax: levied to pay for the maintenance and operation of a taxing jurisdiction, it is limited in the rate at which it can increase from year to year; contrast to “secondary property tax”

Private sector: the part of an economy in which goods and services are produced by individuals and companies, as opposed to the government

Productivity: the rate at which goods or services are produced, especially output per unit of labor

Property tax: tax imposed on ownership of property and measured by its value

Public finance: government revenues and expenditures, or more broadly, what the government should do or is doing, and how to pay for those activities

Public good: consumption by one individual does not reduce availability to others and no one can be effectively excluded from using the good; may lead to market failure, where uncoordinated markets driven by parties working in their own self interest are unable to provide these goods in desired quantities

Public safety: a category of government expenditures that includes police and fire protection, corrections, and inspection and regulation

Public sector: the part of the economy controlled by the government

R

Rainy-day fund: common term for a budget stabilization fund

Real: adjusted for inflation; contrast to “nominal”

Real property: land, buildings, and improvements to the land

Recession: a portion of the economic cycle, a period of economic contraction typically lasting from several months to a little more than a year

Regressive: a tax in which those with lower incomes pay a higher share of their income than those with higher incomes

Responsiveness: one of the revenue system guiding principles: revenues should grow at the same rate as the economy in the long term

Revenue: the income of a government from taxation, user fees, or other sources, which is appropriated to the payment of the public expenses

S

Sales factor: emphasis on the sales portion of the property-payroll-sales formula used to determine corporate income tax liability

- Sales tax:** tax applicable with only specified exceptions (e.g., food and prescribed medicines) to sales of all types of goods (and sometimes services)
- Secondary property tax:** levied to pay for bond indebtedness, voter-approved budget overrides, and special districts; contrast to “primary property tax”
- Selective sales tax:** taxes imposed on the sale of particular commodities or services apart from the general sales tax
- Severance tax:** a tax imposed by a state on the extraction of natural resources, such as oil, coal, or gas, that will be used in other states
- Simplicity:** one of the revenue system guiding principles: the revenue system should minimize the costs of compliance and administration
- Social welfare:** broadly defined as social services provided by a government to its citizens, it typically refers to the services received by the disadvantaged
- Special assessment:** a tax levied by a local government on private property to pay the cost of local public improvements, such as sidewalk construction or sewage disposal, which are of general benefit to the property taxed
- Special district:** a political subdivision of a state established to provide a single public service, such as fire protection or sanitation, within a specific geographical area
- Stability:** one of the revenue system guiding principles: the year-to-year fluctuation in revenue over an economic cycle should be minimized
- Statute:** A law enacted by a legislature, contrast to “Constitution”
- Structural deficit:** the deficit that remains across the business cycle because the general level of government spending is too high for prevailing revenues; contrast to “cyclical deficit”
- Students FIRST:** the current method of funding school construction from a centralized state funding system, largely from the state’s general fund
- Supermajority:** a majority of some percentage more than a simple majority of 50% plus one
- Supply side:** an economic theory that increased availability of money for investment, achieved through reduction of taxes especially in the higher tax brackets, will increase productivity, economic activity, and income

T

- Tax:** a charge imposed by legislative or other public authority upon persons, groups, or businesses for the support of a government
- Tax burden:** the ratio of tax revenues collected to some measure of income
- Tax credit:** an amount that may be subtracted from the sum of tax otherwise due and that is distinguished from a deduction applied to gross income in the calculation of taxable income
- Tax cut:** a reduction in taxation that may result from a reduction in the tax rate or the narrowing of the tax base, as by passing an exemption
- Tax exemption:** a deduction to the amount of income that is taxable, in contrast to a tax credit that reduces the actual amount of tax owed
- Tax rate:** the proportional amount of taxes paid on a given income, price, or dollar value of an asset
- Tax Reform for Arizona Citizens Committee (TRACC):** a 2002 study of the tax structure
- Temporary Assistance for Needy Families (TANF):** federal assistance program administered by the states, commonly known as “welfare”

Term limits: a statutory limit on the number of terms an official may serve

Three-legged stool: sales, income, and property taxes

Transaction privilege tax (TPT): a general sales tax in which the seller is responsible for remitting the tax

Transfer payments: consists of income payments to persons for which no current services are performed, such as Social Security and other retirement income, and net insurance settlements

U

Urban revenue sharing: passed by Arizona voters in 1972, specifies that a portion of income tax revenues be shared with incorporated cities and towns

Use tax: a state tax imposed on goods purchased outside a state for which state sales tax has not been paid

User fee: a charge for the use of something, such as a city government fee for garbage collection

V

Vehicle license tax: in Arizona, defined as a tax levied on vehicles based on value; as defined by the Census Bureau, various licenses and fees for title registration, license plates, etc.—the vehicle tax based on value is a property tax

Vertical equity: tax payments as a proportion of income should not be higher for those with lower incomes, one of the revenue system guiding principles

Voting rights act: federal act originally passed in 1965 that outlawed discriminatory voting practices; it has been interpreted as requiring racial gerrymandering in order to ensure minority representation

Appendix 4

ACRONYMS

ADOR: Arizona Department of Revenue
AHCCCS: Arizona Health Care Cost Containment System
AGI: adjusted gross income
AZPI: Arizona personal income
BEA: Bureau of Economic Analysis
BSF: budget stabilization fund
CEO: chief executive officer
CFRC: Citizens Finance Review Commission
DNA: deoxyribonucleic acid
DOT: U.S. Department of Transportation
EEC: Economic Estimates Commission
FIRST: Fair and Immediate Resources for Students Today
GAO: Government Accounting Office
GDP: gross domestic product
GMA: Groundwater Management Act
HUD: U.S. Department of Housing and Urban Development
JCCR: Joint Committee on Capital Review
JLBC: Arizona Joint Legislative Budget Committee
NASBO: National Association of State Budget Officers
NCSL: National Conference of State Legislatures
NGA: National Governors Association
R&D: research and development
RMR: revenue maximizing rate
TANF: Temporary Assistance for Needy Families
TPT: transaction privilege tax
TRACC: Tax Reform for Arizona Citizens Committee