Fiscal Alternative Choices Team (FACT) Report

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TABLE OF CONTENTS

Long-Term Options to Strengthen State Government Finances

Appendix

Foreword

On January 26, 2009, Senate President Robert “Bob” Burns sent a letter of invitation to the Arizona Board of Regents and University Presidents, inviting their assistance in examining options for closing Arizona’s widening budget deficit. At the same time, at a meeting with House Speaker Kirk Adams, the Speaker made a similar request of the University System. This report is a response to their request.

In early February, the Regents announced the appointment of the “Fiscal Alternative Choices Team” (FACT), a 10-member team of faculty members and administrators with knowledge of the Arizona economy and state and local finances. The Regents asked Ted Ferris, an economist and former Deputy Chief of Staff to Governor Hull and former Director of the Arizona Joint Legislative Budget Committee for 12 years to lead this effort.

Against the backdrop of a worsening fiscal outlook and an aggressive legislative schedule for completing action on the budget, FACT was given less than two months to complete its work. Accordingly, the group decided to focus its efforts more on developing meaningful options for closing the deficit than on a determination of what economic and policy factors had led to Arizona having the nation’s largest deficit. For more background, see the Appendix.

The group also quickly concluded that it would not spend time attempting to develop an alternative set of budget cuts to that offered by the Legislature, as the Joint Legislative Budget Committee had already developed a wide range of budget reduction options intended to entirely erase the estimated $3 billion budget deficit through cuts.

Instead, this report focuses on options for balancing the budget through strategies for raising revenues (mostly temporary), and through options for shifting funding responsibility or the timing of expenditures to help alleviate the short-term budget crisis. The report also includes strategies for better managing the impact of Arizona’s dynamic, if not volatile economy and state finances.

While this report is intended to present state policymakers with a wide range of options, this report has not been reviewed and approved by the Arizona Board of Regents and, therefore, should not be viewed as a set of recommendations from the Regents nor the University community. Unfortunately, given the state of national and local economies as well as state and local finances, there are no pleasant or easy options. It is our hope that these ideas will help lead to the implementation of budget actions that allow Arizona to successfully navigate through the next few years in a manner that is best for both private and public sector activities.

Therefore, it is vitally important that state policymakers take steps to place the State of Arizona on a more sustainable path for state finances. To that end, the report offers options to improve our future performance.

Fiscal Alternative Choices Team (FACT)
Executive Summary

Backdrop

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

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

Summary of FACT Options

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

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

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

Short-Term Budget Balancing Options

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

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

Seek Voter Approval of Temporary Tax Increases

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

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

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

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

While most of the discussion regarding a temporary tax increase has centered on referring a temporary tax increase to the voters of Arizona at a special election, the State Legislature could enact a temporary tax increase and possibly do so without a Prop 108 two -thirds majority. Under Section 22 of Article IX of the Arizona Constitution a two-thirds majority is required for a bill that increases state revenues, as defined in Section 22. Given that our need is for a short-term infusion of revenues to help bridge the gap over a four fiscal year period, what if a bill provided for additional revenues for a four year period followed by a permanent tax cut beginning in the 5th year and thereafter? The FACT report contains such a simulation for both the sales tax and income tax and offers a structured tax plan for legislation that would amount to a "net tax cutting bill". There is not a lot of legal guidance in this regard, but it is certainly worth debating the merits of such an approach whereby a simple majority of the Legislature could establish a reasonable approach to balancing the budget that smoothes the collections of revenue across the business cycle.

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

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

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

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

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

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

The challenge is that immediate conversion to a flat-income tax would lead to some serious "vertical equity" concerns, as the highest income taxpayers would see a significant tax cut while middle to upper-middle income taxpayers would see a tax increase. The implications of the 5 strategies are all evaluated in the context of widely held attributes of a good revenue system.

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

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

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

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

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

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

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

Currently, over three-quarters of VLT revenues are forwarded to local governments and another 20 percent are deposited into the State Highway Fund. Because the Arizona Department of Transportation (ADOT) does not receive funding through the state's General Fund, they are relatively immune from the state's current budget crisis. This option would not only assist in eliminating the General Fund deficit, it would provide some equity by having the transportation function of government participate in resolving the state's budget deficits.

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

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

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

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

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

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

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

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

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

Long-Term Options to Improve the State General Fund

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

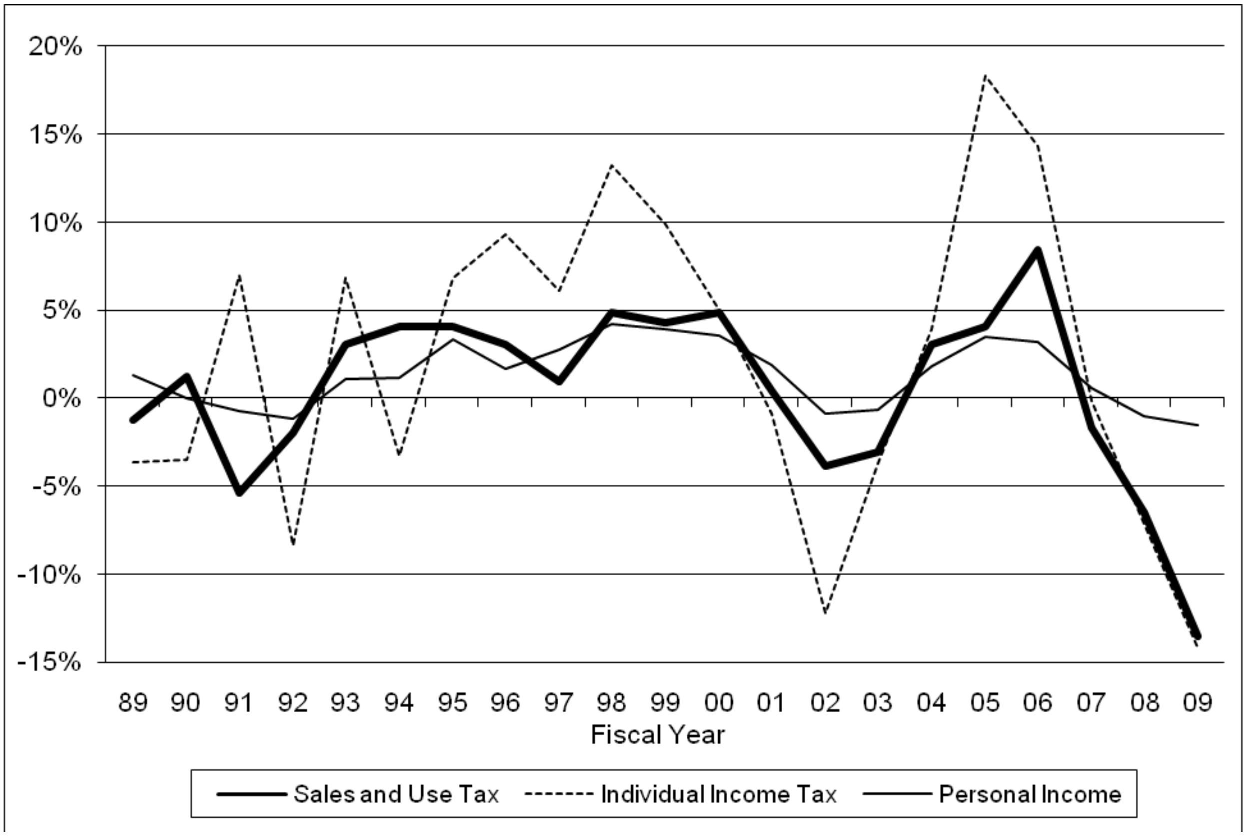
This is a trend we would like to see reversed. While we are offering a number of options to help balance the state budget over the next three fiscal years, it is more important that state policymakers establish a more predictable and stable path for the delivery of vital state and local government services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

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

Create a More “Defensive” State Tax Structure

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

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



Source: Arizona Joint Legislative Budget Committee (revenues) and U.S. Department of Commerce, Bureau of Economic Analysis (personal Income). Data for 2009 are projected. Revenue has been adjusted for changes in the tax code.

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

Creating a more “defensive” tax structure means re-examining past decisions to eliminate General Fund revenues from other more stable tax sources. If you go back three decades, you find that the sales tax and income taxes comprised about 66 percent of state General Fund tax revenues, not 90 percent+ like today. Creating a “defensive” sales tax structure means broadening the sales tax base (while lowering the tax rate) to include expenditure categories that are more stable across the business cycle. Through the years, whether by legislative action or voter initiative, broad areas of commerce that were previously subject to the tax were eliminated. For example, food for consumption at home was eliminated by voter approval in July 1980 and the tax on commercial leases was eliminated in July 1997. As detailed elsewhere in this report, according to the Arizona Department of Revenue (ADOR) publication The Revenue Impact of Arizona's Tax Expenditures FY 2007/08, the loss of revenue associated with these two decisions is over $1 billion.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Further Privatization of State/Local Services

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

Short-Term Budget Balancing Options

The American Recovery and Reinvestment Act (ARRA) Provides Short-Term Stimulus Dollars to State Governments to Help Manage Mounting Budget Deficits throughout the U.S.

For Arizona, over $4 billion of additional federal aid can be realized between now and 2011. Most of the monies are front-loaded with the intent of assisting states with their budget deficits, thereby lessening the loss of jobs and income associated with record budget deficits facing the states.

Most of the new federal aid comes in the form of increased Title 19 (Medicaid) funding or new State Fiscal Stabilization Funds (SFSF) that are directed to Education (a minimum of 81.8 percent) or as General Government aid for any purpose including Education, at a maximum of 18.2 percent.

The increased federal matching assistance program dollars for Medicaid are estimated at $1.9 billion over a 9-quarter period commencing on October 1, 2008 and ending on December 31, 2010. It is estimated that state government's share of this money will be $1.7 billion and Arizona's counties will share approximately $164 million. Some $434 million of the state's share of the new Title 19 monies will be received after FY 2010, meaning that nearly $1.3 billion will be received in FY 2009 or FY 2010.

The federal SFSF monies are estimated at $1.02 billion, of which $832 million is earmarked for Education and another $185 million is earmarked for any general purpose of state government, including Education. These monies are to be applied for by the Governor of each state and used in accordance with rules that are under development by the U.S. Department of Education (ED) and other federal officials.

Preliminary ED rules indicate that the Education dollars are to be applied by the Governors in sequential order to restore FY 2009 funding to the higher of FY 2008 or FY 2009 funding levels for each education sector (K-12 and Higher Ed) and, thereafter, to apply remaining monies toward a partial restoration of Higher Ed funding in FY 2010 to the FY 2008 level, and a partial restoration of K-12 to the "primary funding formula requirement" for K-12 in FY 2010. At all times, Governors must certify that state funding will not slip below FY 2006 Maintenance of Effort (MOE) levels (Governors can request a waiver to cut below MOE levels, in which case, education's share of the overall budget cannot be reduced below their share of the budget in FY 2006).

In total, we are capable of receiving $2.3 billion of additional federal aid this year and next that can be used to reduce the projected deficits of $5 to $5.5 billion, or roughly 40 percent of the deficit can be offset with these monies.

Unfortunately, the budget picture for FY 2009 continues to worsen, and further revenue losses this fiscal year may require a substantial portion of the SFSF monies to be used to balance the current year budget. With nearly one-third of state revenues being collected in the final quarter of the fiscal year, there will be few other good options left to mitigate such a shortfall when it occurs.

Arizona will also be eligible to receive nearly $1 billion of other federal stimulus monies under the ARRA, however, these monies are either awarded on a competitive grant award basis, or, the monies may be restricted in their use and unable to be used to offset or supplant state funding to help balance our budget.

Under any interpretation of the ARRA, the federal stimulus monies made available through the Act are a vital piece of Arizona's budget balancing plan.

Seek Voter Approval of a Multi-Year Limited Tax Increase

This report suggests that a multi-year tax increase will be needed to build a budget over the next four fiscal years. Whether the Legislature refers the question to the voters at a special election, or passes a structured tax increase/decrease tax bill as outlined in this report, the FACT group believes the state needs to measure all of its budget balancing options in terms of their collective impact on the budgets for the next three fiscal years (FY 2010, 2011 and 2012).

If the matter of a temporary tax increase is referred to the voters, it needs to look at all four years and may, in fact, be more palatable if it were to include structural tax reform and future tax reduction.

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

State policymakers' "hands are tied" when it comes to enacting the size of budget cuts necessary to help balance a budget where the deficit is equal to roughly one-third of the size of the baseline budget. Many programs are off-limits to cuts or very limited in their ability to be cut due to federal mandates; now, there are further federal limits due to the MOE requirements in the federal stimulus bill (see the ARRA section of this report); still other programs are protected by the fact they were put into place through the voter initiative process and are protected by the Voter Protection Act, which requires a 3/4 majority vote of the Legislature to amend any voter approved act in a way that redirects program funding, and even then, such redirection can only take place if it furthers a program's purposes.

There has been talk of asking the voters to lift these restrictions in situations of extreme duress like the present time. Perhaps some very limited criteria could be developed whereby the Legislature would be able to redirect certain of these monies in very limited situations. For example, we could ask voters to allow it to occur only in the second or later years of consecutive years where base revenues (adjusted for any legislative change in taxes) actually decline from the prior fiscal year. There have only been a handful of years in the last several decades where this has occurred; unfortunately, three of those years are FY 2008 (actual), FY 2009 (forecasted) and FY 2010 (forecasted). Perhaps we could limit the Legislature's ability to use the funds for other purposes to any fund balances that have accumulated and to some reasonable fraction of the monies that are attributable to that particular voter-approved program or initiative.

A Structured Tax Increase and Tax Decrease Proposal that Would Represent an Overall Tax Cut May Not Require a Super-Majority for Enactment

The discussion of a temporary tax increase to help solve Arizona's enormous budget deficit (in addition to budget cuts, federal stimulus monies, and other actions) has centered on the referral of a temporary tax increase to Arizona voters at a special election, since a bill that raises state revenues would otherwise require a two-thirds vote of the Legislature. However, there may be an approach that yields additional near-term revenues for the next four fiscal years in combination with lowered revenues in year five and permanently thereafter. While it is open to interpretation, and there is not much in the way of judicial guidance in this regard, it may be possible to structure a bill where the overall fiscal impact is a reduction in state revenues; thereby, not requiring a super majority for enactment under Section 22 of Article IX of the State Constitution (Prop 108).

For example, regardless of whether the additional short-term revenues are derived from an increase in sales tax (transaction privilege tax) or personal income tax rates, a possible schedule of the change in revenue is as follows:

FY 2010	plus $1,000 million
FY 2011	plus $1,000 million
FY 2012	plus $750 million
FY 2013	plus $250 million
FY 2014 and thereafter	minus $200 million

In this example, revenues are nominally increased by $3 billion from FY 2010 through FY 2013 and are nominally decreased $4 billion over the next 20 years (and an even greater amount if viewed over the next 30 or 40 years as the change would be permanent).

This example shows peak additional revenues in both FY 2010 and FY 2011, because all of the federal stimulus monies (SFSF) will have been deployed to help balance the budgets in FY 2009 and FY 2010, so there is a continuing need in FY 2011. There would also be a need to continue budget cuts in FY 2011 that are as high if not higher than required in FY 2010. The JLBC long-term revenue forecast does not have FY 2007 revenue levels returning until FY 2012, so this scenario would retain three-quarters of the tax increase in place for FY 2012 and one-quarter of the increase in place for FY 2013. The resumption of more normal revenue growth thereafter will provide the wherewithal for the tax cuts that would commence in FY 2014.

Temporarily Increase the Transaction Privilege (General Sales Tax) Rate, And Then Permanently Reduce the Rate

In order to temporarily boost General Fund revenue, this proposal increases the sales tax rate for the four additional fiscal years during which weak economic conditions are expected to continue to result in significant deficits in the General Fund. After that, the sales tax rate will be reduced permanently to below the existing rate of 5 percent. Because the net effect over the life of the legislation would be a tax cut, it is possible that this option would not require a supermajority of the Legislature to be enacted.

A permanent reduction in the rate is recommended due to the state's heavy dependence on the sales tax as a revenue source. Collections from the sales tax are volatile across the economic cycle and do not keep pace with economic growth (the tax currently is limited to goods, and the share of retail purchases for goods is declining). However, the proposed permanent decrease in the rate is intended to be part of a comprehensive package of fiscal reform that is implemented during the next few years. Otherwise, adopting this option in isolation will increase the size of the structural deficit and cause an even more severe budget deficit during the next economic downturn.

Given the current volume of taxable sales, a one cent increase in the sales tax rate (i.e. raising the state rate from 5 percent to 6 percent) would raise just more than $1 billion in tax revenue for the state. If the state wanted to share the increase with the counties and municipalities that are also experiencing record budget shortfalls, the net increase to the state would fall to roughly $800 million. As the economy recovers, the boost to revenue from a one cent increase in rate will rise (apart from inflation and population growth).

This revenue projection assumes no change in purchasing activity due to the increase in tax rate. Given the lack of options to avoid the tax increase — few Arizona residents will travel to another state to purchase goods — and the small magnitude of any tax increase (e.g. for an item retailing for $100, the state's general sales tax would rise from $5 currently to $6), the negative effect on retail sales from a tax increase is expected to be very slight.

Tax rates and revenues were projected based on the goal of increasing General Fund revenue by $1 billion in fiscal years 2010 and 2011, $750 million in 2012, and $250 million in 2013. After that, collections will be reduced to below what they would be if the rate were 5 percent in order to achieve a net decrease in tax collections over time.

The projections assume that the annual growth rate of nominal taxable sales over time will be equal to the sum of a 1.4 percent gain in real per person sales, 2.5 percent inflation, and the population growth rate. The state's "official" population projections indicate that the population growth rate is projected to gradually fall from 2.8 percent in 2010 to 0.8 percent in 2050. A discount rate of 2.5 percent is assumed.

Assuming an increase in the sales tax is shared with Arizona's county and municipal governments, an increase in General Fund revenue of $1 billion in each of the next two fiscal years would require the sales tax rate to increase from 5 percent to 6.25 percent. A revenue gain in 2012 of $750 million would require a tax rate of about 5.85 percent; a rate of around 5.25 percent would produce nearly $250 million gain in 2013. If the rate was then reduced permanently to 4.8 percent, the revenue in 2014 would be approximately $200 million less than if the rate were the current 5 percent. The annual reduction in revenue would increase thereafter to reflect inflation, population growth, and gains in real per person expenditures.

Using net present value analysis, it can be demonstrated that the increase in revenues between 2010 and 2013 would be nearly completely offset in 2026 by the permanent tax rate cut that takes effect in 2014. By 2040, cumulative revenues would be $4.7 billion less than if the state rate remained at 5 percent over this period. It is on this basis that it is suggested that legislation structured along these lines could be passed by a simple majority vote of the Legislature, since the net effect of the bill in total would be a tax cut for Arizona.

Temporarily Increase the Individual Income Tax Rate, And Then Permanently Reduce the Rate

This proposal increases the individual income tax rate for the four years that reduced government revenues are expected to last. After that, the income tax rate will be reduced permanently below the 2008 rates. Since the proposed net tax change is a tax reduction, this option may not require either the approval of the electorate or a supermajority of the Legislature.

This option, designed as a short-run solution to the fiscal crises, would result in a permanent reduction in the individual income tax rate from the 2007 rates. In 2007, Arizona ranked 39th in per capita income tax collections among the 41 states with income taxes, so our income taxes are low compared to other states ($511 per capita). (Two additional states tax only dividends and interest income, not wages.) There have been seven cuts in the individual income tax rates since 1993 and the tax cut proposed as part of this short-term solution would continue those decreases when fully implemented. The income tax is an important component of an overall state tax structure because it alone can be used to mitigate regressive aspects of other state taxes. Thus, the individual income tax and the rates/brackets should be reevaluated over the next few years as part of a comprehensive package of fiscal reform. Possible individual income tax simplification proposals are examined elsewhere in this report.

A portion of the individual income tax is shared with incorporated cities and towns via the Urban Revenue Sharing Formula, which distributes 15 percent of the individual income tax revenues that were collected two years previously. Thus, increasing the individual income tax rate to generate additional revenues in fiscal year 2010 would not provide additional revenues to cities and towns until 2012. Thus, this proposal would remove the additional income tax revenues from the Urban Revenue Sharing Formula (see the alternative below) and leave all additional revenue in the General Fund.

Tax rates and revenues are based on the goal of increasing General Fund revenue by $1 billion in fiscal years 2010 and 2011, $750 million in 2012, and $250 million in 2013. After that, rates will be reduced below current rates in order to provide $200 million in tax cuts in 2014. Thereafter, the projections assume that the annual growth rate of taxable income over time will be equal to the sum of a 1.8 percent increase in real per capita income, 2.5 percent inflation, and the projected population growth rate. The state's "official" population projections indicate that the population growth rate is expected to gradually fall from 2.8 percent in 2010 to 0.8 percent in 2050. A discount rate of 2.5 percent is assumed.

An increase in General Fund revenue of $1 billion in each of the next two fiscal years would require a 31 percent increase in rates (from 2007 rates of 2.59, 2.88, 3.36, 4.24, and 4.54 for each of the five brackets to rates of 3.39, 3.77, 4.40, 5.55, and 5.95 percent). These rates are similar to those that existed in 1994. A revenue gain in 2012 of $750 million would require tax rates 23 percent above 2007 rates and a gain in 2013 of $250 million would require tax rates 7 percent above the 2007 rates. If the rates were then reduced permanently by 6.5 percent below the 2007 rates, revenues would be $200 million less in 2014 than expected levels. The annual reduction in revenue would increase thereafter to reflect inflation, population growth and gains in real per person income. Note that if incorporated cities and towns are “held harmless” in 2014 when income tax rates are cut, the General Fund will lose more than $200 million.

The increase in revenues in early years would be more than offset by the 2014 permanent tax rate by 2026. By 2040, cumulative revenues would be almost $5 billion less than if the rates stayed at 2007 rates throughout the period.

An alternative would be to a) increase the tax rates by an additional amount that would raise 15 percent to be distributed to cities and towns and b) create a temporary Urban Revenue Sharing formula that distributes this new temporary revenue without the two year lag in distribution.

Defer Elimination of Statewide Equalization Tax Payment and Scheduled Business Tax Cuts Until 2012

The state equalization property tax payment (in support of the schools) was suspended for the 2006 though 2008 tax years (FY 2007 through FY 2009). The estimated tax savings if it were continued in FY 2010 is roughly $250 million, which translates into an increased state appropriation for K-12 Basic State Aid. With budget deficits of roughly $2 billion in FY 2009 and $3 to $3.5 billion in FY 2010 and FY 2011, now may not be the time to exacerbate our budgetary challenges by making this change permanent.

Likewise, legislation enacted in 2007 (Ch. 258) accelerated the timeframe for reducing the assessment ratio on commercial and industrial (Class 1) property from the prior level of 25 percent in 2005 to 20 percent by 2011. Previously, Laws 2005, Ch. 302 had scheduled the Class 1 assessment ratio to decline from 25 percent to 20 percent over a 10-year period ending in 2015. Ch. 258 also accelerated the depreciation of business personal property in a way that also increases the state cost of K-12 basic state aid.

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

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

Transfer Vehicle License Tax Revenues from Highway Use to General Government

The option here is not to increase the Vehicle License Tax (VLT) rates; rather to transfer the funds from the State Highway Fund to the General Fund and/or remove the tax entirely from Highway User Revenue Funds (HURF).

The VLT is an ad valorem tax levied on registered vehicles in the state. The tax is levied per $100 of a vehicle's assessed value. For the first 12 months of the vehicle's life, the assessed value is 60 percent of the manufacturer's base retail price. For each subsequent year, the assessed value is 16.25 percent less than the previous year. The rate per $100 of assessed value is $2.80 for new vehicles and $2.89 for renewals.

The VLT, as an ad valorem tax, is not a highway user fee. The level of the VLT tax paid by an individual has nothing to do with highway use. Rather, the tax is based on the value of the vehicle and is comparable to a property tax on motor vehicles. These types of taxes were originally designed to improve horizontal equity. Property taxes on real property have been around for a long time, but not everyone chooses to allocate their money the same way. Some people prefer to own vehicles instead of owning real property. By imposing a tax on the value of vehicles, then two individuals with similar incomes and wealth – one who purchases real estate and one who purchases vehicles – are treated equitably. Because vehicles tend to depreciate over time, the VLT tax is imposed on a depreciating assessed value of the vehicle.

Article IX, Section 14, of the Arizona Constitution explicitly says that all fuel taxes, licenses and registration fees associated with motor transport be earmarked for highways (construction, state traffic enforcement, bond payments, etc.). The VLT is explicitly excluded from being earmarked for highways in the constitution because it is unrelated to highway use and is intended to be a tax on personal property and, as such, should be spent for general government purposes.

In the late 1990s, the General Fund received a substantial portion of the VLT tax. In FY1998, total VLT collections were approximately $587 million and the General Fund received almost 29 percent, or $168.8 million. The tax rate was decreased and the sharing formulas were changed in the Laws of 1998 and 1999. HURF and local governments were "held harmless" with regard to the tax cut so the combined impact of the changes was to virtually eliminate the VLT from General Fund revenues.

In FY2008, collections from the VLT were approximately $859 million and the General Fund received less than $2.3 million. Of total VLT collections, $662 million is ultimately distributed to local governments, including money distributed directly from VLT for General Fund purposes (close to half of $859 million) and money distributed through HURF for transportation purposes. Of the $385 million deposited into HURF, $176 million was deposited into the State Highway Fund and the rest was shared with state and local government entities for highway purposes.

Assuming no change in collections from the VLT from 2008 through 2010, approximately $176 million can be transferred to the General Fund from the State Highway Fund. If additional funding is needed, up to $385 million of VLT collections deposited into HURF could be set aside through changes in the VLT distribution formulas and deposited into the General Fund.

Whether just VLT money in the State Highway Fund is transferred to the General Fund or whether the VLT is completely removed as a source of highway funding and dedicated to general government purposes, the loss in highway-related revenues should be made up through increases in other highway-related taxes, fees and licenses.

In addition, all highway taxes that are imposed on a per license, per vehicle, per gallon basis should be indexed to the Consumer Price Index (CPI) and be adjusted every one to three years. For example, the current $0.18/gallon tax rate on motor vehicle fuel (gasoline) was set in 1990. The CPI increased almost 68 percent over this period. Had the motor vehicle fuel tax rate increased accordingly, the current rate would be $0.30/gallon and revenues from that tax alone would have been almost $350 million higher in 2008, assuming no change in gallons consumed as a result of the higher tax. The tax on use fuel (primarily diesel) for large commercial vehicles was $0.18 in 1990 and increased to $0.26 in 2004. This increase precisely matched the increase in the CPI for the 1990-2004 period, but it should be indexed to the CPI in order to sustain revenues needed for transportation over time. Increasing the use fuel tax to $0.30 would raise $32 million, assuming no change in gallons consumed as a result of the tax.

According to the Census Bureau, Arizona's collections from highway-related taxes and licenses are also very low. According to the Census Bureau, highway-related taxes and licenses include fees for title registration, license plates, vehicle inspection, vehicle mileage and weight taxes on motor carriers, highway use taxes and off-highway fees. In 2006, per capita collections by Arizona state and local governments (virtually all of these taxes are state-imposed in Arizona) were 54 percent less than the national average, ranking Arizona 49th in the nation. Such fees could be doubled, raising a little more than $200 million, yet the state would remain just below the national average in terms of per capita collections.

There are numerous opportunities to increase fees and other motor vehicle-related taxes for the transfer of the VLT to the General Fund.

Raising Monies through Sale-Leaseback Programs

Investment markets are in disarray nationally and internationally. With significant losses being reported in most asset classes, investors are looking for opportunities where the risk of asset loss is small and reasonable returns can be obtained. A viable opportunity may exist where states can borrow against the value of their assets in a sale-leaseback program. While limited in scope, states have entered into these agreements previously and are considering them now.

Examples of actual or proposed public sale-leaseback programs.

1. In 2006, Indiana leased the Indiana Toll Road for 75 years for $3.8 billion.
2. Chicago entered into a sale-leaseback program in 2005 for the Chicago Skyway toll road, parking ramps and parking meters for $3.5 billion.
3. Chicago has proposed leasing Midway Airport for $2.5 billion pending approval of the FAA.
4. Pennsylvania proposed leasing the Pennsylvania Turnpike for $12.8 billion over 75 years, but investors withdrew when the Legislature failed to act.
5. In Minnesota, lawmakers are pushing to privatize the Minnesota-St. Paul International Airport and the state lottery. If approved, it is estimated that the airport could generate $2.5 billion and the lottery could generate $500 million.
6. Massachusetts lawmakers are considering putting the Massachusetts Turnpike in private hands. That could bring in upfront money while also saving on highway operating costs.
7. In New York, a commission has been appointed to look into leasing state assets, including the Tappan Zee Bridge north of New York City, the lottery, golf courses, toll roads, parks and beaches.

Sales-leaseback programs can be constructed in a variety of ways. Conceptually, the state is exchanging the receipt of money now with the commitment of repaying that money with interest over a period of years to the investor. The asset acts as collateral that can continue to be used, but insures that future payments are made by the state.

There are investment companies willing to consider sales-leaseback programs for state and local governments that are based upon either the value of the land or the buildings or both asset classes. In economic circumstances such as the present, a sales-leaseback program is worth considering as a “stop-gap” measure.

Consider Additional “Rollover” of State Payments for Higher Education and AHCCCS

Historically, on occasion, the Legislature has implemented a strategy of moving the timing of the June K-12 Basic State Aid payment into July as a means of helping to balance the state budget. This effectively moves the payment into the next fiscal year, meaning the state only has to account for 11 state aid payments in the first year, but would have to account for 13 payments in the following year. However, if the so-called “rollover” payment is continued in the second year, there would be only 12 payments until such time when the “rollover” is reversed.

Currently, the state is operating with a double “rollover” of K-12 state aid payments, having deferred both the May and June payments into July and August. As a consequence, the state has an unfunded obligation of over $600 million that will have to be reversed at some future time.

Other state payments eligible for “rollover” include the June payment to the state’s three universities and the medical payments to providers under the Arizona Health Care Cost Containment System (AHCCCS) program (state managed health care to working poor and indigent populations). The state could potentially push some $160 million into a future fiscal year with a “rollover” of June payments into July.

One critical aspect of any such consideration, however, is to analyze the state’s cash flow (State Treasurer’s Office), to be sure that any such “rollover’s” are manageable within the state’s constrained cash position.

Do Not Cut Positions in Revenue-Producing Agencies Like the Department of Revenue and the State Land Department

In the midyear cuts for FY 2009, some 200 positions were reportedly eliminated from ADOR. The State Land Department was also cut. The Legislature should consider having these agencies self-funded through a portion of the revenues they generate. Their budgets would still be subject to Legislative appropriation, but should be removed from General Fund appropriations in order to insulate these agencies from budget cuts at a time when we need these agencies to produce more, not less, revenues. With Governor Brewer just announcing a Tax Amnesty program for Arizona, the staffing reduction at ADOR seems counter-intuitive to what needs to be accomplished when revenues are falling so far short of estimates.

Long-Term Options to Strengthen State Government Finances

Modify the Operation of the Budget Stabilization Fund

A rainy-day fund is designed to set aside revenue during times of strong economic growth to be spent during periods of weak growth or recession. Because of the severe cyclicality of the Arizona economy and the heavy use of cyclical revenue sources, General Fund revenue collection in Arizona is more cyclical than in the average state, making the existence of a rainy-day fund of particular importance in Arizona.

When the economy is strong, use of a rainy-day fund helps control public expenditures by setting aside, rather than spending, excess revenue. Continued public spending during a recession using rainy-day monies helps mitigate the impact of a recession. With an adequately designed and funded rainy-day fund, the cyclical loss of revenue during an economic downturn that leads to difficult spending decisions and the hardships caused by budget cuts could be largely avoided.

The Arizona Legislature created a Budget Stabilization Fund (BSF) in 1990. It was capped at 15 percent of the General Fund with transfers to and from the BSF -prescribed by a formula based on economic growth rates. However, the cap was reduced to 7 percent, and fund transfers rarely have been in line with the formula.

Arizona's rainy-day fund has not come close to meeting the needs in either of the recessions since the BSF was created. Simulations of the operation of the BSF going back to the early 1970s reveal two primary weaknesses in the current BSF statute:

- Capping the BSF at 7 percent of the General Fund provides a very inadequate amount of monies to transfer to the General Fund during a typical economic downturn. Even a 15 percent cap does not guarantee that the BSF will have enough funds in a long and deep economic recession.
- The existing formula does not transfer nearly enough monies to the BSF during years of strong economic growth for the fund to reach a 15 percent balance before the next economic downturn.

Further, over the last 15 years, the Legislature has reduced the effectiveness of the BSF through statutory changes, used the fund for other purposes, and made ad hoc rather than formula-recommended transfers to and from the fund. The operation of the budget stabilization fund can be viewed as a budgeting procedure not needing legislative oversight. The existing statute could be changed in either of two ways:

- Specify the operation of the BSF in the state constitution rather than in statute. Constitutional provisions that transfers to and from the fund be made automatically without legislative action and that the BSF be allowed to attain at least 15 percent of General Fund revenue would ensure the effectiveness of the BSF.

- Tighten the statutory language by having the Economic Estimates Commission annually proclaim the required fund transfer, with the Legislature forbidden to alter the funding except in an emergency and as approved by a three-fourths vote.

Even if the BSF attains a 15 percent balance during each economic expansion, revenue-expenditure imbalances could still occur during economic downturns. A severe economic downturn could cause revenue to drop so much for such a long period of time that the BSF could be exhausted before cyclical deficits disappear. The likelihood of this possibility has been increased due to changes in the revenue mix implemented since the early 1990s that have increased the volatility and decreased the responsiveness of the revenue stream.

The BSF balance also will be inadequate to deal with budget deficits if decisions to increase expenditures without creating a new funding source and/or to reduce taxes without adopting associated spending cuts continue. Indeed, Arizona's current budget deficit is due more to a structural than cyclical deficit. A rainy-day fund cannot overcome a structural deficit. However, had the BSF cap not been reduced in the mid-1990s, then some of the tax cuts implemented since then might not have occurred and the current structural deficit would not be as large.

In addition to cyclical swings in revenue that can be resolved by a properly designed BSF, the state also experiences fluctuations in expenditures. Some of this variability is not easily predicted: judicial decisions sometimes order the state to expend funds, and some programs (such as alternative fuels) experience unexpected expenses. This suggests that a contingency fund (much smaller in size than the BSF) under the discretion of the Legislature be created. Monies could be transferred to the contingency fund during periods of strong economic growth when a surplus remains even after the formula-specified transfer to the BSF.

Some expenditure fluctuations are predictable. The loss of jobs and income that occur during recessions — which are inevitable — results in increased demands on health and welfare programs such as the Arizona Health Care Cost Containment System (AHCCCS) during each downturn. An additional contingency fund could be used to smooth out these cyclical fluctuations in expenditures. Alternatively, this function could be added to the design of the BSF. If so, the size of transfers to and from the BSF would need to be increased and the cap would need to be raised beyond 15 percent.

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

In summary, the following actions are proposed:

1. Increase the cap of the BSF to at least 15 percent.
2. Change the funding formula so that substantially more monies are transferred to the BSF during periods of strong economic growth.

3. Either tighten the statutory language or place the operation of the BSF into the Constitution.
4. Create another contingency fund to deal with unexpected funding needs.
5. Either create a third contingency fund to deal with cyclical expenditure needs in health and welfare or expand the size and role of the BSF.
6. Eliminate the existing structural deficit.
7. Do not create a new structural deficit: do not increase spending without increasing revenue and do not reduce taxes without reducing spending.

Expand the Sales Tax Base and Lower the Tax Rate

As it is currently structured, Arizona's general sales tax compares poorly against fiscal guiding principles. Its narrow base — primarily nonfood goods — introduces cyclicality in the revenue flows, lowering stability and predictability. The tax's responsiveness to economic growth is poor since it does not include many services that are growing in popularity. Its efficiency is poor given its high and variable state and local rate by jurisdiction and its narrow base. The high state and local tax rate hinders economic competitiveness by raising the cost of doing business — since some purchases by businesses are taxed as well as those by individuals. The large number of exemptions negatively affects neutrality and horizontal equity, and vertical equity is poor because of the high regressivity. Finally, the general sales tax is highly complex given all of the exceptions and the fact that the Legislature allows municipalities to establish differing tax rates and taxable activity by community. For example, while the state rate has not been applied to the purchase of food for home consumption for nearly three decades, there are municipalities that apply a tax of up to 3 percent on food.

The Arizona Department of Revenue in "The Revenue Impact of Arizona's Tax Expenditures FY 2007/08" estimated that approximately $10 billion in additional revenue could be raised at a 5 percent tax rate if all sales tax exemptions and preferential tax rates were ended. This is a conservative figure in that no information is available to estimate the revenue impact in many categories. However, some of the largest dollar effects are from exemptions that likely should not be eliminated, such as sales of articles to be incorporated into manufactured goods, health care, business services, professional services, and wholesale trade. Still, the potential revenue enhancement from taxing some services and by removing certain other exemptions reaches into the billions of dollars.

A complete list of the possible options for extending the sales tax is not available, as certain categories are not included in the Department of Revenue report. Among the most likely candidates are taxing personal services, educational services, and auto repair (estimated revenue of $199 million), wages and salaries for labor employed in construction ($772 million), food to be consumed at home ($687 million), and commercial leases ($413 million). While the sum of the estimated revenue from these sources exceeds $2 billion, the General Fund portion would be about $1.6 billion after revenue sharing. Actual figures might be marginally less since the imposition of a sales tax might cause slight reductions in the demand for the newly taxed services.

The net gain in revenue would be less if low-income tax credits were adopted to lessen regressivity. Such tax credits would be especially important if food to be consumed at home is taxed. With properly administered low-income tax credits, low-income households could be unaffected by new taxes on services and food.

If the expansion of the sales tax base were undertaken with the objective of raising no new money, the 5 percent state sales tax rate could be reduced to approximately 3.67 percent. Alternatively, the tax rate could be reduced while still raising additional revenue. For illustration, if the statewide tax rate were reduced from 5 percent to 4.4 percent, General Fund collections would increase by approximately $860 million from the expansion of the base as described above. Including the Proposition 301 tax rate of 0.6 percent, the combined general sales tax rate would be 5 percent. This is a 10.7 percent reduction in tax rates that all current retailers would experience.

Arguments that a tax on services will hurt small businesses fail to acknowledge the inherent inequities that prevail today between small retailers (currently taxed) and small service providers (not currently taxed). Furthermore, all businesses that purchase goods subject to the sales tax would benefit from a lower tax rate.

Adopting a Simplified Personal Income Tax With Flat or Graduated Tax Rates

The key provision of this proposal is to simplify Arizona's personal income tax by eliminating all deductions, additions and subtractions to income. Instead, standard exemptions will be increased and the state tax will be based strictly on federal adjusted gross income. The calculation of the tax due could be done through either a flat tax rate or a graduated tax rate, in which the tax rate rises with income.

Summary of Flat Tax and Graduated Tax Options
Five options were considered. The first two use a flat tax rate, with standard exemptions differing between the two options. The other three options use some form of a graduated tax rate. The first two of these graduated tax options correspond to the two flat tax options.

A brief summary of the results for in-state tax filers relative to the actual taxes paid in 2007 follows; details are available in the Appendix. The data source is the Arizona Department of Revenue's abstract of all tax returns filed in the 2007 calendar year. Results will vary when the tax abstracts for more recent years become available. All results should be verified with the DOR income tax model.

1. Flat tax with $20,000 in exemptions for a family of four: a standard exemption of $7,500 ($15,000 for a married couple filing jointly) and a deduction of $2,500 per dependent.
In order to hold revenue roughly equal to the actual figure, the tax rate is 2.78 percent. The total number of tax filers is greater than in the status quo: fewer at the lowest incomes but more at all other incomes. The average tax burden rises for those with incomes between $15,000 and $200,000, particularly for those from $30,000 to $150,000, and falls for others. For those earning more than $500,000, a large decrease occurs. About $325 million in tax burden is transferred from very high-income to other taxpayers.

2. Flat tax with $40,000 in exemptions for a family of four: a standard exemption of $17,000 ($34,000 for a married couple filing jointly) and a deduction of $3,000 per dependent.
In order to hold revenue roughly equal to the actual figure, the tax rate is 3.58 percent. The total number of tax filers is much less than in the status quo: fewer at incomes of less than $40,000 but more at higher incomes. The average tax burden rises for those with incomes between $50,000 and $500,000, especially for those between $75,000 and $200,000. Taxes are lowered especially for those with incomes less than $25,000 and more than $1 million. However, the transfer in tax burden from very high incomes is less than in the first option at $90 million. Thus, this is seen as a more acceptable option than option 1.

3. Graduated tax with $20,000 in exemptions for a family of four.
Actual effective tax rates by income bracket were the starting point for determining the new rates, but existing rates had to be adjusted up to raise equivalent revenue to that actually received because of the increase in the size of the standard exemptions. The number of tax filers and the adjusted gross income is the same as in option 1. While many sets of

graduated rates could be created, the illustrated rates hold the effective rate in the highest tax bracket equal to the actual rate. The effective tax rate gradually rises from 1.5 percent to 4.0 percent. The effect is a tax decrease for those earning less than $50,000 and little change in the tax due in the higher income brackets. Despite the net decrease in taxes due by income bracket, more filers must pay taxes than under the existing tax code so that total revenue is as high as the actual figure.

4. Graduated tax with $40,000 in exemptions for a family of four.
The number of tax filers and the adjusted gross income is the same as in option 2. Because of the large size of the standard exemptions, it is not possible to achieve a solution where the average tax due is no higher than under the actual tax code for all tax brackets without applying a *higher* tax rate for low-income than high-income earners. Thus, this option is inferior to option 3.

5. A two-tiered rate with $30,000 in exemptions for a family of four: a standard exemption of $12,000 ($24,000 for a married couple filing jointly) and a deduction of $3,000 per dependent.
The number of tax filers declines, though not by as much as in option 2. The number decreases through incomes of $30,000 and rises at higher incomes. The tax rate is 2.8 percent up to an income of $200,000. The marginal rate then becomes 4.1 percent. The effective tax rate is 2.8 percent through $200,000, then gradually rises to 4.02 percent for those with incomes of at least $1 million. The results are similar to those of multi-tiered option 3, except that a small tax increase occurs among those with incomes between $50,000 and $150,000.

Effect on Regressivity
Most taxes are regressive: as a percentage of income, low-income households pay more than high-income households. The existing income tax is an exception; it is progressive, and is intended to be so in order to offset some of the regressivity of other taxes.

Yet, net regressivity remains within Arizona's tax system. According to the annual study of state and local government tax burden produced by the Government of the District of Columbia, the tax burden in Arizona is much higher at the lowest income than at higher incomes, both as a percentage of income and in relationship to other states:

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

	Household Income				
	$25,000	**$50,000**	**$75,000**	**$100,000**	**$150,000**
Rank Among 51 'States'					
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

The DC data are for 2007, matching the income tax data used in the flat tax and graduated tax options.

At the income ranges included in the DC study, the effect of replacing the existing income tax with option 2 (the second flat tax option) will be to marginally reduce the tax burden at $25,000, but to slightly raise the burden at the $75,000 through $150,000 income levels. However, at much higher incomes, the tax burden will drop.

The effect of option 3 (the first graduated tax option) will be to marginally reduce the tax burden at the lowest income and essentially have no effect at other incomes.

Fiscal System Guiding Principles
The guiding principles listed below were developed based on multiple inputs, including drafts of the Citizens Fiscal Review Commission (CFRC) guiding principles, the Fiscal 2000 principles, the literature review, and comments made at CFRC Technical Advisory Committee meetings. Nationally, general agreement exists regarding the guiding principles, but the list of principles can be organized and grouped in a number of ways and the terminology and definition of terms vary. The principles listed below are ordered from the broadest considerations to more micro concepts.

The sufficiency of revenue aspect of the first principle is beyond the scope of this report. However, adequate revenue is absolutely critical to a well-functioning fiscal system.

1. Accountability: Link revenues and expenditures.
   - 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.

2. 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. If revenues in a year exceed expenditures and the predetermined payment into the Budget Stabilization Fund, the excess either should be placed in a rainy day fund or rebated; permanent changes to the tax code should not be made.

3. 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.

4. 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 to keep pace with changing technology, economic mix, and societal structure. Frequent ad hoc changes negatively affect predictability as well as other guiding principles.
- An adequately funded Budget Stabilization Fund greatly enhances predictability.

5. 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.

6. 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.

7. 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.

8. 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.

9. 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.

10. 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.

11. Simplicity: The revenue system should be designed to minimize compliance and administrative costs.

- 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.

In the following tables, the performance of Arizona's personal income tax relative to these guiding principles is evaluated based on the existing tax code and on the proposed changes to a flat tax or to a graduated tax. Neutrality, horizontal equity, and simplicity is improved in both the flat tax and graduated tax options.

The tradeoff between the flat tax and graduated tax is largely one of competitiveness versus vertical equity. Competitiveness is improved in the flat tax option but not the graduated tax option — but competitiveness already is good. Vertical equity will be lessened in the flat tax option while improved in the graduated rate option. In addition, the flat tax option will result in a modest improvement in stability and predictability.

A QUALITATIVE ASSESSMENT OF THE PERSONAL INCOME TAX RELATIVE TO THE GUIDING PRINCIPLES

AS CURRENTLY STRUCTURED IN ARIZONA

Guiding Principle	Evaluation	Comments
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	OK	The federal code is very complex but the state does not add significantly to the complexity

AS SIMPLIFIED, WITH FLAT TAX RATE

Guiding Principle	Evaluation	Comments
2. Stability and 4. Predictability	Poor	Modest improvement will be realized by reducing the share of taxes collected from the highest income earners, who have the most volatile incomes
3. Responsiveness	Good	
5. Efficiency	Good	
6. Competitiveness	Very Good	Improved due to a reduction in the marginal tax rate
7. Exportability	Poor	
8. Neutrality	Good	Improved due to the elimination of tax credits
9. Horizontal Equity	Good	Improved due to the inability of some taxpayers to largely or wholly avoid the tax
10. Vertical Equity	OK	Worsened: progressivity is lost through the use of a flat tax rate, which is only partially mitigated by an increase in the size of the standard exemption
11. Simplicity	Very Good	Improved: while the federal code remains very complex, the state code is made as simple as possible

AS SIMPLIFIED, WITH GRADUATED TAX RATES

Guiding Principle	Evaluation	Comments
2. Stability and 4. Predictability	Poor	
3. Responsiveness	Good	
5. Efficiency	Good	
6. Competitiveness	Good	
7. Exportability	Poor	
8. Neutrality	Good	Improved due to the elimination of tax credits
9. Horizontal Equity	Good	Improved due to the inability of some taxpayers to largely or wholly avoid the tax
10. Vertical Equity	Very Good	Improved: progressivity is maintained through the use of graduated tax rates and is improved because of increase in size of the standard exemption
11. Simplicity	Very Good	Improved: while the federal code remains very complex, the state code is made as simple as possible

Provide a Funding Source for School Construction and Renovation

When the “Students FIRST” program was enacted nearly a decade to go, the cost of constructing new schools and renovating existing schools was shifted from local property taxes (not equalized) to the state General Fund. Several hundred million dollars of expenditures were shifted to the state without a funding source. Since then, the state has used both revenue bonds and “pay-as-you-go” financing to fund the obligations of the state School Facilities Board (Students FIRST).

The development of Students FIRST was in response to a lawsuit and was enacted under the watchful eye of the State Supreme Court. Therefore, any alternative funding strategy would have to address the fundamental basis for the lawsuit and the court’s involvement. One option that would return funding of the school capital program to the property tax, but likely pass Constitutional muster, would be to levy a statewide secondary property tax rate on all properties, based upon a uniform assessment ratio (business and residential property being assessed at the same assessment ratio, say 10 percent).

As suggested elsewhere in this report, the decision of whether to fund new construction through revenue bonds or on a “pay-as-you-go” basis could be left for future legislatures to decide. However, the tax rate could be started lower and stepped up over time, if revenue bonds are used.

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

In 1998, the Legislature adopted “Students FIRST,” in which the state General Fund is used to fund capital needs of school districts. In most years since the passage of this legislation, the General Fund expenditures for school capital needs have been between $300 million and $500 million.

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

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

The basic principle of efficient capital budgeting applies to the decision to put public infrastructure in place, be it in the form of public highways, prisons, elementary and secondary schools, water treatment facilities, or university buildings. To minimize costs and maximize public benefit, policymakers should make building decisions that consider the advantages of access to capital markets. A newly constructed school yields direct benefits (analogous to net revenue in the private sector) to students over the life of the school and indirect benefits to society that span generations. Similarly, roads deliver benefits over their lifetime of use. These benefits accrue to people who have yet to move to Arizona and to future generations, that is, future but not current taxpayers.

Debt financing is an appropriate mechanism for public capital investments because the benefits of the new physical capital extend far beyond the year in which the facility is constructed. For example, financing a school over its lifetime is an efficient way of matching benefits to costs in the same manner that private-sector firms match future net revenue to continuing debt service. Failure to utilize debt financing is unfair to current taxpayers — especially the elderly who may not live to realize the benefits — and inefficient since a suboptimal amount of public infrastructure is put in place to serve current and future needs.

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

A compromise that accepts this rationale but also considers the strong cyclicality of General Fund revenues is to use the existing funding mechanism in years of strong economic growth but to automatically use bonding whenever economic growth slows. Suppose that since fiscal year 1999, school construction had been paid in cash out of the General Fund during years when the Arizona economy grew rapidly. This spending obligation would have been removed from the General Fund in other years, with debt financing used to fund construction in fiscal years 2001, 2002, 2007 and 2008. The accumulated savings from debt financing would have been nearly $1 billion, which would have reduced the budget deficit in those years.

Investigate Further Options for "Privatizing" Additional State Government Functions

A long-term option that many state governments are considering is to partner with private sector employers in the provision of public-sector goods and services. In many instances, the private sector performs similar work or can develop necessary expertise. Where the function can be provided at lower costs, more quickly, or with improved customer service, using private-sector businesses can achieve numerous efficiencies.

States, and all levels of government, have approached privatizing in various ways. Sometimes it is at the function level. For example, data processing functions are often contracted out to large firms that have expertise and resources that are not readily available within public agencies. Other functions range from printing and copying to the provision of accounting and auditing services. Many of the internal business functions of state government are similar to the work of the private sector and therefore lend themselves to be outsourced.

In other cases, it is not the individual business function that is privatized, but the complete operation. For example, many states have contracted with private firms to provide prison services, K-12 education, or eligibility determination for human service programs. These contracts cover the full range of functions and services to replicate or replace the public-sector program.

Arizona has a long tradition of privatizing its services. For example, some prisoners who would otherwise be housed in a Department of Corrections facility are instead housed in private facilities both within and outside Arizona. Elementary and secondary education is provided to nearly 100,000 students by over 450 charter schools in Arizona. As well, eligibility determination for food stamps and other human services are provided under contract by a private provider, mirroring work performed by the Department of Economic Security.

The challenge is determining the scope and magnitude of privatizing state government. In some cases, it is a more efficient and cost-effective approach. In other situations, the benefits are small or non-existent. Each case needs to be evaluated on its merits.

Appendix

- Senate President Burns Letter of January 26, 2009 and FACT Response
- Summary of ASU Reports by Dennis Hoffman and Tom Rex
- Recommendations of 2003 Citizens Finance Review Commission
- Comparison to Recommendations of the 2003 Citizens Finance Review Commission

ROBERT L. BURNS
DISTRICT 9

PRESIDENT OF THE SENATE
FORTY-NINTH LEGISLATURE

COMMITTEES:

RULES, CHAIRMAN
LEGISLATIVE COUNCIL, CHAIRMAN
LIBRARY, ARCHIVES & PUBLIC RECORDS CHAIRMAN

Arizona State Senate

January 26, 2009

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Gentlemen:

I have read several recent statements from each of you regarding the impact reductions to your state appropriations could have on our state universities. I understand and respect your concerns.

Every day, reports cross my desk that provide new details on the deepening economic recession. Some of these reports include statistics and analyses generated by economists from Arizona public universities.

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Page 2

January 26, 2009

Many of your statements to the press have expressed a desire to work with the Legislature and to put your analytical resources to work to help us deal with our budget deficit. Some of you have also suggested that tax increases be enacted to avoid reductions in university spending. I am taking you up on your offer and want to know more about what you may have in mind. Allow me to suggest an approach the Legislature may find helpful.

Please have the appropriate faculty and researchers in your institutions provide a compilation and analysis of economic indicators relating to the private sector in a manner that contrasts, where applicable, with similar data specific to the public sector of our economy.

I would ask that this report on the relative economic status of the private and public sectors include, but not necessarily be limited to, the latest information on the following:

- Job losses or pay reductions
- Employee retirement accounts
- Home foreclosures
- Business and department/agency closings
- Reductions in revenue generated by taxable activities, incomes, values, etc.
- Impact of credit market changes and access to capital
- Impact of current taxation levels on economic activity as well as the impact of specific tax increases you may have in mind.

I ask that these compiled reports be submitted directly to each of you and that you then forward these reports to me with your recommendations (collectively or individually, as you prefer) on what additional cuts or tax increases you would propose in the context of the economic situation these reports describe.

You have expressed a desire to avoid enacting policies that will, as President Crow alluded, cause Arizona to resemble a Third World country. I understand the point through the hyperbole. I would only add that I also wish to avoid tax policies that protect and expand government institutions at the expense of Arizona citizens and businesses that are simply hoping government will not exacerbate their current problems.

Sincerely,

Robert L. Burns

RLB:meh

Response to President Burns Letter of January 26, 2009

The Fiscal Alternative Choices Team is pleased to reply to the January 26 letter from Senate President Robert “Bob” Burns (attached), which invited the input of the Universities with respect to a wider range of options for erasing Arizona’s large and rising budget deficits. Specifically, President Burns asked that the relative economic status of the private and public sectors be compared. The FACT group must report that other than preliminary employment estimates, current data are unavailable to make that comparison for most of the questions you posed. Indeed, no differentiation between the public and private sectors is available for most of the indicators that were listed in the Burns letter.

Of more importance, however, is that a direct comparison between the private and public sectors is often misleading. Most of the private sector is negatively affected during an economic recession, because demand for their goods and services significantly declines. The decline in demand comes from (1) consumers who have lost jobs or income or otherwise are concerned about their financial situation, (2) declining demand from other businesses, and (3) government agencies that reduce their spending.

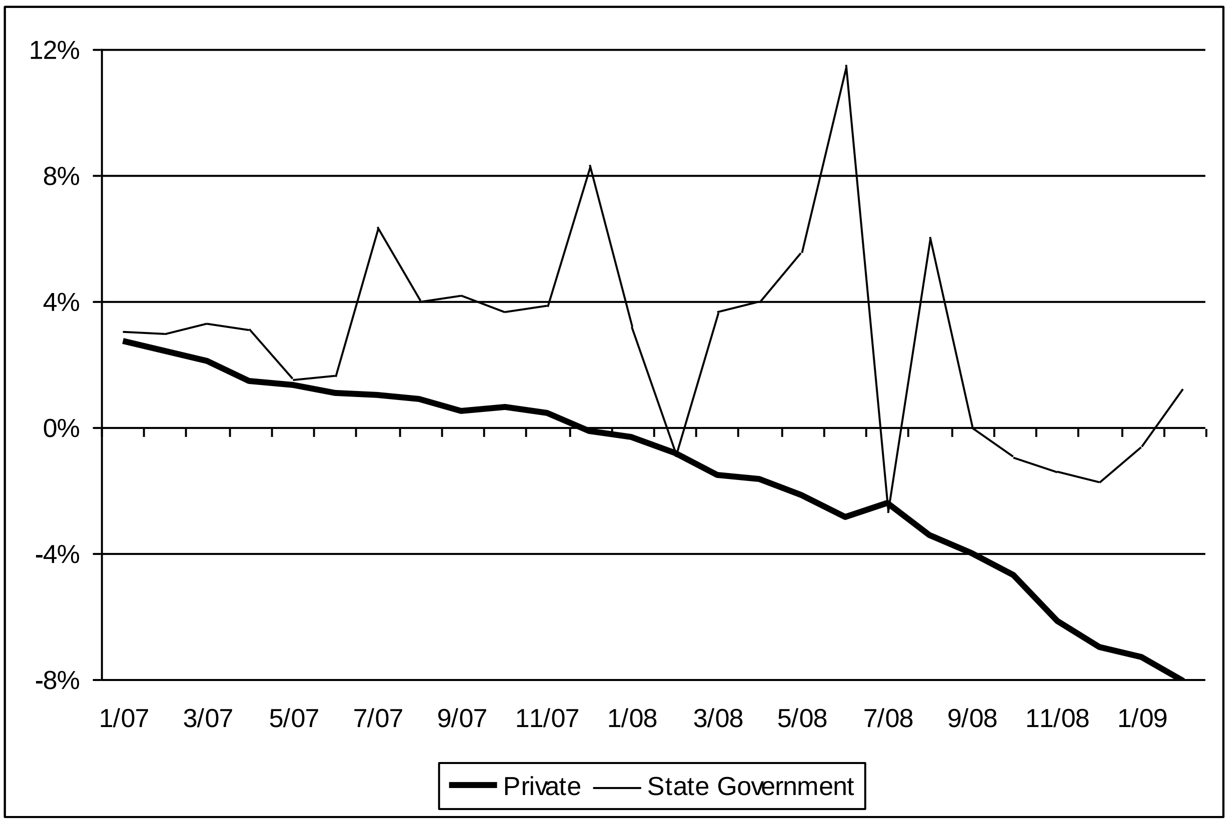
The decrease in demand in the private sector is the direct cause of reductions in business activity, employee layoffs, and in some cases the failure of a business. However, some private-sector activities do not experience a significant drop in demand, with health care being a prime example. As a result, the health care industry continues to expand during recessions, albeit at a slower rate than during economic expansions. Similarly, there are certain other sectors of the private economy that do not recede as much during a recession and, in fact, their stocks (in the case of publicly traded companies) become desirable during a downturn as their sales and profitability do not decline as much. Examples in the current recession are Johnson & Johnson, McDonald’s, and Wal-Mart.

The public sector, on the other hand, is like health care and unlike most of the private sector, with the exception of certain companies whose products are more in demand when times are tough. The public’s demand for most government services does not decrease during a recession. In fact, many critical public services experience a countercyclical increase in demand, particularly the demand for public assistance, health care and unemployment assistance. Higher education also experiences an increase in demand during protracted deep recessions, since some of the unemployed seek to use their available time to further their education or to learn a new trade.

State government employment (including the Universities) has increased much less than private-sector employment for a number of years in Arizona. Between 1995 and 2007, private-sector employment increased 60 percent while state government employment rose only 8 percent. Only in 2002, reflecting the 2001 recession and the slow recovery from the recession, did annual average employment in state government increase faster than in the private sector.

The prior analysis reflects the latest data for total employment from the U.S. Department of Commerce. More recent data are available from the U.S. Department of Labor, but these figures are based on a sample and measure only wage and salary employment. Employment changes from the latter source are displayed in the following chart through February 2009. The year-over-year percent changes in state government employment are highly erratic by month. However, since last summer, state government employment has on average been flat despite increases in demand for most programs. In contrast to the declining employment in all of the private sector, health care employment continues to rise, though at a slowing pace.

YEAR-OVER-YEAR PERCENT CHANGE IN ARIZONA EMPLOYMENT



Source: U.S. Department of Labor and Arizona Department of Commerce (Current Employment Statistics)

Senate President Burns' letter also asked about the impacts of tax increases and government spending reductions. It is important to note that during a recession both tax increases and government spending reductions will have a negative economic impact. Thus, it is of utmost importance during the expansionary phase of the economic cycle to prepare for the next downturn in the economy by depositing substantial amounts of money into a budget stabilization fund. (As we explain elsewhere in this report the 7 percent cap on Arizona's fund is greatly insufficient and should be increased to at least 15 percent, as originally envisioned when enacted in 1990, with your important sponsorship at the time.)

During a recession, the question becomes one of minimizing the negative impact on the economy. The REMI economic forecasting/economic impact estimating model for Arizona was used to estimate the effects of tax increases and government spending reductions. (The IMPLAN model produced similar results.) The results of modeling the actual state government spending reduction of $584.5 million in FY 2009 and additional spending reductions and/or revenue increases of $1 billion in FY 2010 are shown in the following table. The negative economic effects are most severe in the scenario that reduces government spending, and least serious in the scenario that raises public-sector revenue.

While total job losses are least in the revenue enhancement scenario, private-sector job losses are somewhat greater in that scenario than in the other two scenarios. However, government absorbs a disproportionate share of the job losses in each scenario because of the large spending reduction passed in February 2009 that is assumed to continue in FY 2010. Compared to a 13 percent share of total employment in 2007, government would account for 28 percent of the job losses in 2010 in the revenue enhancement scenario, 43 percent in the mix of spending reduction and revenue enhancement scenario, and 55 percent in the spending reduction scenario.

ECONOMIC EFFECTS OF BALANCING THE ARIZONA STATE GOVERNMENT GENERAL FUND IN 2009 AND 2010

	1st Scenario: Spending Reduction	2nd Scenario: Revenue Enhancement	3rd Scenario: Mix of Both
EMPLOYMENT			
2009	-23,950	-19,550	-21,750
2010	-35,670	-27,670	-31,670
GROSS PRODUCT (in millions)			
2009	$-1,493	$-1,353	$-1,424
2010	-2,278	-2,067	-2,174

Source: Calculated from the REMI model

The revenue enhancement scenario assumes a personal tax increase. Currently, personal tax burdens in Arizona are very low compared to other states, while corporate tax burdens in Arizona do not compare so favorably. Increases in business taxes instead of personal taxes will result in greater negative effects than public spending reductions.

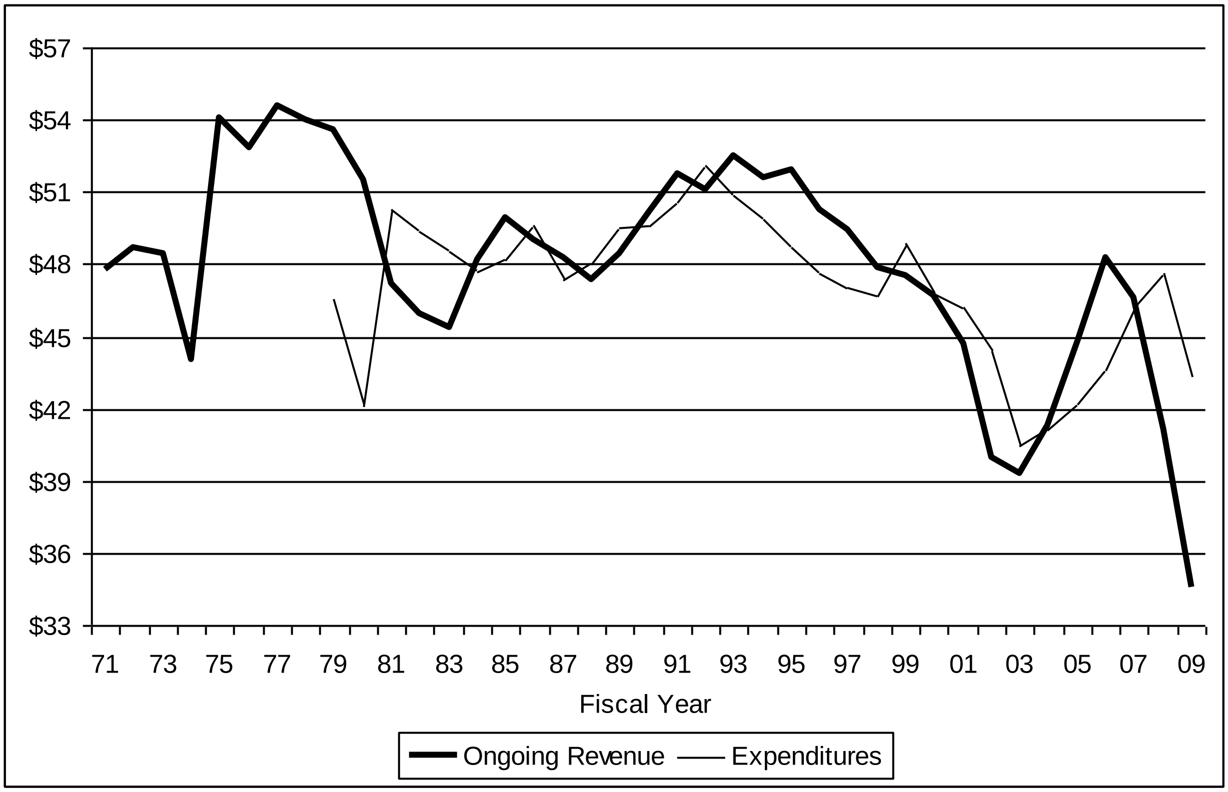
Government spending reductions have more severe negative effects than tax increases for several reasons. A portion of any tax increase would reduce savings rather than consumption, lessening its impact on the economy in the short run, whereas the full amount of government spending cuts on goods and services would directly reduce consumption. Less spending for goods and services by governments will result in reduced demand for private-sector goods and services. If spending reductions are accomplished by employee layoffs, then private-sector businesses are affected further as laid-off workers either leave the state or cut back substantially on their purchases. It is not realistic to expect that many laid-off government employees will find jobs in Arizona until the recession has ended.

Government spending reductions severely affect a small number of businesses and state residents (state government employees and workers at businesses that sell to the state). In contrast, a personal tax increase will spread the negative effects throughout the state, with the effect on any individual and on any business being minor. In addition, a high percentage of state government expenditures are made directly to state residents and local businesses, while some of the expenditures of individuals quickly leave the state. Also, a personal tax increase may be deductible from federal taxes and therefore exported to the federal government. A portion also may be exported to tourists and other nonresidents.

A temporary increase in the sales tax of 1.25 cents, in conjunction with the use of low-income tax credits to minimize the negative effects on low-income households, would increase state General Fund revenue by about $1 billion per year, assuming that revenue sharing with counties and municipalities continues. A tax increase of this magnitude would be approximately $150 per year per Arizona resident, or about $400 per year for the average-sized household. This is a considerably lesser amount than the federal tax rebate of 2008 and the federal tax reductions in 2009 and in 2010. Using the Tax Foundation's tax burden data, Arizona still would be a low-tax state after implementing such a tax increase, ranking 37th.

At the conclusion of Senate President Burns' letter, the Senator noted that he wished to avoid tax policies that "protect and expand government institutions at the expense of Arizona citizens and businesses." However, our analysis shows that a personal tax increase would have a lesser impact on Arizona residents and businesses than government spending cuts. Further, the FACT group believes that it is not a matter of "protecting and expanding government." Our analysis shows that Arizona state government has shrunk over time relative to the size of the economy, with spending at the peak in fiscal year 2008 still less than in most earlier years, as seen in the following graph. Over the 31-year time period, the 2009 spending figure is fifth lowest overall, and the lowest for education.

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



Sources: Arizona Joint Legislative Budget Committee (revenues and expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income). Data for 2009 are projected.

Supporting Tables for Adopting a Simplified Personal Income Tax With Flat or Graduated Tax Rates

PERSONAL INCOME TAX SUMMARY, ACTUAL AND OPTIONS, IN-STATE TAXPAYERS ONLY
STATUS QUO

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	4,409	$20,190,078	$84,666	0.42%	$19
5,000 to 9,999	84,137	668,790,466	4,760,663	0.71	57
10,000 to 14,999	99,107	1,240,378,409	14,624,240	1.18	148
15,000 to 19,999	133,787	2,361,096,184	27,006,625	1.14	202
20,000 to 24,999	156,819	3,528,834,175	41,996,292	1.19	268
25,000 to 29,999	148,535	4,080,686,062	54,787,915	1.34	369
30,000 to 34,999	135,768	4,405,737,158	64,946,639	1.47	478
35,000 to 39,999	118,111	4,422,894,287	68,913,236	1.56	583
40,000 to 49,999	191,271	8,562,017,833	138,030,678	1.61	722
50,000 to 74,999	325,249	20,008,918,075	333,887,555	1.67	1,027
75,000 to 99,999	199,350	17,218,974,939	315,563,348	1.83	1,583
100,000 to 149,999	167,729	20,113,314,145	418,885,655	2.08	2,497
150,000 to 199,999	55,033	9,408,846,328	227,370,119	2.42	4,132
200,000 to 499,999	54,361	15,613,427,761	459,468,050	2.94	8,452
500,000 to 999,999	9,806	6,654,138,633	237,139,939	3.56	24,183
1,000,000 or More	5,583	18,185,544,357	726,312,236	3.99	130,094
Totals	1,889,055	136,493,788,890	3,133,777,856	2.30	1,659

Option 1: FLAT TAX: First $20,000 Tax Free for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	0	$0	$0		
5,000 to 9,999	60,492	74,419,665	2,068,867	2.78%	$34
10,000 to 14,999	108,225	521,815,000	14,506,457	2.78	134
15,000 to 19,999	135,016	1,037,278,461	28,836,341	2.78	214
20,000 to 24,999	168,892	1,648,523,397	45,828,950	2.78	271
25,000 to 29,999	162,618	2,267,382,953	63,033,246	2.78	388
30,000 to 34,999	146,785	2,778,356,345	77,238,306	2.78	526
35,000 to 39,999	126,045	3,023,911,501	84,064,740	2.78	667
40,000 to 49,999	200,925	6,258,979,376	173,999,627	2.78	866
50,000 to 74,999	335,670	15,739,421,552	437,555,919	2.78	1,304
75,000 to 99,999	202,587	14,310,369,317	397,828,267	2.78	1,964
100,000 to 149,999	169,185	17,540,847,600	487,635,563	2.78	2,882
150,000 to 199,999	55,338	8,557,973,749	237,911,670	2.78	4,299
200,000 to 499,999	54,617	14,791,008,107	411,190,025	2.78	7,529
500,000 to 999,999	9,844	6,519,351,913	181,237,983	2.78	18,411
1,000,000 or More	5,622	18,187,850,427	505,622,242	2.78	89,936
Totals	1,941,861	113,257,489,363	3,148,558,204	2.78	1,621

Option 2: FLAT TAX: First $40,000 Tax Free for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	0	$0	$0		$0
5,000 to 9,999	0	0	0		0
10,000 to 14,999	0	0	0		0
15,000 to 19,999	45,953	68,389,884	2,448,358	3.58%	53
20,000 to 24,999	85,764	422,725,140	15,133,560	3.58	176
25,000 to 29,999	77,901	769,026,003	27,531,131	3.58	353
30,000 to 34,999	72,692	1,054,139,059	37,738,178	3.58	519
35,000 to 39,999	82,766	1,254,063,132	44,895,460	3.58	542
40,000 to 49,999	189,787	3,142,261,450	112,492,960	3.58	593
50,000 to 74,999	335,322	10,023,675,392	358,847,579	3.58	1,070
75,000 to 99,999	202,585	10,575,108,713	378,588,892	3.58	1,869
100,000 to 149,999	169,182	14,335,298,770	513,203,696	3.58	3,033
150,000 to 199,999	55,338	7,501,239,749	268,544,383	3.58	4,853
200,000 to 499,999	54,616	13,746,464,623	492,123,434	3.58	9,011
500,000 to 999,999	9,844	6,331,411,413	226,664,529	3.58	23,026
1,000,000 or More	5,622	18,080,723,927	647,289,917	3.58	115,135
Totals	1,387,372	87,304,527,255	3,125,502,076	3.58	2,253

Option 3: MULTI-TIERED GRADUATED TAX: $20,000 of Exemptions for Family of Four and Effective Tax Rates From Status Quo, Adjusted Up So That Total Revenue Is Equivalent

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	0	$0	$0	1.50%	$0
5,000 to 9,999	60,492	74,419,665	1,190,715	1.60	20
10,000 to 14,999	108,225	521,815,000	8,870,855	1.70	82
15,000 to 19,999	135,016	1,037,278,461	18,671,012	1.80	138
20,000 to 24,999	168,892	1,648,523,397	31,321,945	1.90	185
25,000 to 29,999	162,618	2,267,382,953	45,347,659	2.00	279
30,000 to 34,999	146,785	2,778,356,345	58,345,483	2.10	397
35,000 to 39,999	126,045	3,023,911,501	66,526,053	2.20	528
40,000 to 49,999	200,925	6,258,979,376	140,827,036	2.25	701
50,000 to 74,999	335,670	15,739,421,552	354,136,985	2.25	1,055
75,000 to 99,999	202,587	14,310,369,317	321,983,310	2.25	1,589
100,000 to 149,999	169,185	17,540,847,600	420,980,342	2.40	2,488
150,000 to 199,999	55,338	8,557,973,749	226,786,304	2.65	4,098
200,000 to 499,999	54,617	14,791,008,107	458,521,251	3.10	8,395
500,000 to 999,999	9,844	6,519,351,913	237,956,345	3.65	24,173
1,000,000 or More	5,622	18,187,850,427	727,514,017	4.00	129,405
Totals	1,941,861	113,257,489,363	3,118,979,312	2.75	1,606

Option 4: MULTI-TIERED GRADUATED TAX: $40,000 of Exemptions for Family of Four and Effective Tax Rates from Status Quo, Adjusted Up So That Total Revenue is Equivalent

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	0	$0	$0	3.30%	$0
5,000 to 9,999	0	0	0	3.30	0
10,000 to 14,999	0	0	0	3.30	0
15,000 to 19,999	45,953	68,389,884	2,256,866	3.30	49
20,000 to 24,999	85,764	422,725,140	13,949,930	3.30	163
25,000 to 29,999	77,901	769,026,003	25,377,858	3.30	326
30,000 to 34,999	72,692	1,054,139,059	34,786,589	3.30	479
35,000 to 39,999	82,766	1,254,063,132	41,384,083	3.30	500
40,000 to 49,999	189,787	3,142,261,450	103,694,628	3.30	546
50,000 to 74,999	335,322	10,023,675,392	335,793,126	3.35	1,001
75,000 to 99,999	202,585	10,575,108,713	359,553,696	3.40	1,775
100,000 to 149,999	169,182	14,335,298,770	494,567,808	3.45	2,923
150,000 to 199,999	55,338	7,501,239,749	262,543,391	3.50	4,744
200,000 to 499,999	54,616	13,746,464,623	487,999,494	3.55	8,935
500,000 to 999,999	9,844	6,331,411,413	231,096,517	3.65	23,476
1,000,000 or More	5,622	18,080,723,927	723,228,957	4.00	128,643
Totals	1,387,372	87,304,527,255	3,116,232,942	3.57	2,246

Option 5: TWO-TIERED GRADUATED TAX: $30,000 of Exemptions for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax
0 to 4,999	0	$0	$0		$0
5,000 to 9,999	0	0	0		0
10,000 to 14,999	60,557	90,341,940	2,529,574	2.80%	42
15,000 to 19,999	97,479	517,831,775	14,499,290	2.80	149
20,000 to 24,999	91,171	892,806,298	24,998,576	2.80	274
25,000 to 29,999	111,218	1,277,440,581	35,768,336	2.80	322
30,000 to 34,999	132,958	1,755,590,222	49,156,526	2.80	370
35,000 to 39,999	123,349	2,114,893,180	59,217,009	2.80	480
40,000 to 49,999	200,573	4,778,418,875	133,795,728	2.80	667
50,000 to 74,999	335,651	13,073,767,885	366,065,501	2.80	1,091
75,000 to 99,999	202,586	12,572,316,864	352,024,872	2.80	1,738
100,000 to 149,999	169,185	16,045,317,100	449,268,879	2.80	2,655
150,000 to 199,999	55,338	8,065,634,749	225,837,773	2.80	4,081
200,000 to 499,999	54,616	14,305,449,623	447,050,393	3.13	8,185
500,000 to 999,999	9,844	6,431,932,413	238,114,829	3.70	24,189
1,000,000 or More	5,622	18,138,638,927	729,066,996	4.02	129,681
Totals	1,650,147	100,060,380,432	3,127,394,283	3.13	1,895

PERSONAL INCOME TAX SUMMARY, DIFFERENCES FROM ACTUAL, IN-STATE TAXPAYERS ONLY

Option 1: FLAT TAX: First $20,000 Tax Free for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax	Percent Change in Average Tax*
0 to 4,999	-4,409	$-20,190,078	$-84,666	-0.42%	$-19	-0.77%
5,000 to 9,999	-23,645	-594,370,802	-2,691,796	2.07	-22	-0.30
10,000 to 14,999	9,118	-718,563,409	-117,783	1.60	-14	-0.11
15,000 to 19,999	1,229	-1,323,817,723	1,829,716	1.64	12	0.07
20,000 to 24,999	12,073	-1,880,310,777	3,832,659	1.59	4	0.02
25,000 to 29,999	14,083	-1,813,303,109	8,245,331	1.44	19	0.07
30,000 to 34,999	11,017	-1,627,380,813	12,291,668	1.31	48	0.15
35,000 to 39,999	7,934	-1,398,982,786	15,151,504	1.22	83	0.22
40,000 to 49,999	9,654	-2,303,038,457	35,968,949	1.17	144	0.32
50,000 to 74,999	10,421	-4,269,496,522	103,668,364	1.11	277	0.44
75,000 to 99,999	3,237	-2,908,605,622	82,264,919	0.95	381	0.44
100,000 to 149,999	1,456	-2,572,466,545	68,749,908	0.70	385	0.31
150,000 to 199,999	305	-850,872,579	10,541,551	0.36	168	0.10
200,000 to 499,999	256	-822,419,654	-48,278,025	-0.16	-924	-0.26
500,000 to 999,999	38	-134,786,720	-55,901,956	-0.78	-5,772	-0.77
1,000,000 or More	39	2,306,070	-220,689,994	-1.21	-40,157	-1.34
Totals	52,806	-23,236,299,527	14,780,349	0.48	-38	

Option 2: FLAT TAX: First $40,000 Tax Free for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax	Percent Change in Average Tax*
0 to 4,999	-4,409	$-20,190,078	$-84,666	-0.42%	$-19	-0.77%
5,000 to 9,999	-84,137	-668,790,466	-4,760,663	-0.71	-57	-0.75
10,000 to 14,999	-99,107	-1,240,378,409	-14,624,240	-1.18	-148	-1.18
15,000 to 19,999	-87,834	-2,292,706,299	-24,558,267	2.44	-149	-0.85
20,000 to 24,999	-71,055	-3,106,109,034	-26,862,732	2.39	-91	-0.41
25,000 to 29,999	-70,634	-3,311,660,059	-27,256,784	2.24	-15	-0.06
30,000 to 34,999	-63,076	-3,351,598,099	-27,208,460	2.11	41	0.13
35,000 to 39,999	-35,345	-3,168,831,155	-24,017,776	2.02	-41	-0.11
40,000 to 49,999	-1,484	-5,419,756,383	-25,537,718	1.97	-129	-0.29
50,000 to 74,999	10,073	-9,985,242,683	24,960,024	1.91	44	0.07
75,000 to 99,999	3,235	-6,643,866,226	63,025,544	1.75	286	0.33
100,000 to 149,999	1,453	-5,778,015,375	94,318,041	1.50	536	0.43
150,000 to 199,999	305	-1,907,606,579	41,174,264	1.16	721	0.41
200,000 to 499,999	255	-1,866,963,138	32,655,383	0.64	558	0.16
500,000 to 999,999	38	-322,727,220	-10,475,410	0.02	-1,157	-0.15
1,000,000 or More	39	-104,820,430	-79,022,319	-0.41	-14,958	-0.50
Totals	-501,683	-49,189,261,635	-8,275,780	1.28	594	

Option 3: MULTI-TIERED GRADUATED TAX: $20,000 of Exemptions for Family of Four and Effective Tax Rates From Status Quo, Adjusted Up So That Total Revenue Is Equivalent

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax	Percent Change in Average Tax*
0 to 4,999	-4,409	$-20,190,078	$-84,666	1.08%	$-19	-0.77%
5,000 to 9,999	-23,645	-594,370,802	-3,569,948	0.89	-37	-0.49
10,000 to 14,999	9,118	-718,563,409	-5,753,385	0.52	-66	-0.52
15,000 to 19,999	1,229	-1,323,817,723	-8,335,613	0.66	-64	-0.36
20,000 to 24,999	12,073	-1,880,310,777	-10,674,347	0.71	-82	-0.37
25,000 to 29,999	14,083	-1,813,303,109	-9,440,256	0.66	-90	-0.33
30,000 to 34,999	11,017	-1,627,380,813	-6,601,155	0.63	-81	-0.25
35,000 to 39,999	7,934	-1,398,982,786	-2,387,183	0.64	-56	-0.15
40,000 to 49,999	9,654	-2,303,038,457	2,796,358	0.64	-21	-0.05
50,000 to 74,999	10,421	-4,269,496,522	20,249,430	0.58	28	0.05
75,000 to 99,999	3,237	-2,908,605,622	6,419,962	0.42	6	0.01
100,000 to 149,999	1,456	-2,572,466,545	2,094,687	0.32	-9	-0.01
150,000 to 199,999	305	-850,872,579	-583,815	0.23	-33	-0.02
200,000 to 499,999	256	-822,419,654	-946,799	0.16	-57	-0.02
500,000 to 999,999	38	-134,786,720	816,406	0.09	-10	0.00
1,000,000 or More	39	2,306,070	1,201,781	0.01	-689	-0.02
Totals	52,806	-23,236,299,527	-14,798,543	0.46	-53	

Option 4: MULTI-TIERED GRADUATED TAX: $40,000 of Exemptions for Family of Four and Effective Tax Rates from Status Quo, Adjusted Up So That Total Revenue is Equivalent

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax	Percent Change in Average Tax*
0 to 4,999	-4,409	$-20,190,078	$-84,666	2.88%	$-19	-0.77%
5,000 to 9,999	-84,137	-668,790,466	-4,760,663	2.59	-57	-0.75
10,000 to 14,999	-99,107	-1,240,378,409	-14,624,240	2.12	-148	-1.18
15,000 to 19,999	-87,834	-2,292,706,299	-24,749,759	2.16	-153	-0.87
20,000 to 24,999	-71,055	-3,106,109,034	-28,046,362	2.11	-105	-0.47
25,000 to 29,999	-70,634	-3,311,660,059	-29,410,057	1.96	-43	-0.16
30,000 to 34,999	-63,076	-3,351,598,099	-30,160,050	1.83	0	0.00
35,000 to 39,999	-35,345	-3,168,831,155	-27,529,153	1.74	-83	-0.22
40,000 to 49,999	-1,484	-5,419,756,383	-34,336,050	1.69	-175	-0.39
50,000 to 74,999	10,073	-9,985,242,683	1,905,570	1.68	-25	-0.04
75,000 to 99,999	3,235	-6,643,866,226	43,990,348	1.57	192	0.22
100,000 to 149,999	1,453	-5,778,015,375	75,682,152	1.37	426	0.34
150,000 to 199,999	305	-1,907,606,579	35,173,272	1.08	613	0.35
200,000 to 499,999	255	-1,866,963,138	28,531,444	0.61	483	0.14
500,000 to 999,999	38	-322,727,220	-6,043,422	0.09	-707	-0.09
1,000,000 or More	39	-104,820,430	-3,083,279	0.01	-1,451	-0.05
Totals	-501,683	-49,189,261,635	-17,544,913	1.27	587	

Option 5: TWO-TIERED GRADUATED TAX: $30,000 of Exemptions for Family of Four

Income Bracket ($)	Number of Filers	Adjusted Gross Income	Tax Due	Effective Tax Rate	Average Tax	Percent Change in Average Tax*
0 to 4,999	-4,409	$-20,190,078	$-84,666	-0.42%	$-19	-0.77%
5,000 to 9,999	-84,137	-668,790,466	-4,760,663	-0.71	-57	-0.75
10,000 to 14,999	-38,550	-1,150,036,469	-12,094,665	1.62	-106	-0.85
15,000 to 19,999	-36,308	-1,843,264,409	-12,507,335	1.66	-53	-0.30
20,000 to 24,999	-65,648	-2,636,027,877	-16,997,715	1.61	6	0.03
25,000 to 29,999	-37,317	-2,803,245,481	-19,019,579	1.46	-47	-0.17
30,000 to 34,999	-2,810	-2,650,146,936	-15,790,112	1.33	-109	-0.33
35,000 to 39,999	5,238	-2,308,001,107	-9,696,227	1.24	-103	-0.28
40,000 to 49,999	9,302	-3,783,598,958	-4,234,949	1.19	-55	-0.12
50,000 to 74,999	10,402	-6,935,150,190	32,177,946	1.13	64	0.10
75,000 to 99,999	3,236	-4,646,658,075	36,461,524	0.97	155	0.18
100,000 to 149,999	1,456	-4,067,997,045	30,383,224	0.72	158	0.13
150,000 to 199,999	305	-1,343,211,579	-1,532,346	0.38	-50	-0.03
200,000 to 499,999	255	-1,307,978,138	-12,417,657	0.18	-267	-0.08
500,000 to 999,999	38	-222,206,220	974,890	0.14	6	0.00
1,000,000 or More	39	-46,905,430	2,754,760	0.03	-412	-0.01
Totals	-238,908	-36,433,408,458	-6,383,572	0.83	236	

* Relative to the Mid-Point of the Income Bracket

Citizens Finance Review Commission Summary

The Citizens Finance Review Commission was established in 2003 to review Arizona's public finance system. They offered the following 36 recommendation in 6 theme areas.

Economic Vitality

1. The state should move toward reducing overall business property tax burdens.
2. The state should reduce the business personal property tax on locally assessed business personal property.
3. The state should apply a uniform assessment ratio on all future voter-approved property tax-funded bonds and overrides.
4. The state should align the transaction privilege tax to more appropriately mirror the state's economy by expanding the tax base.
5. The state should 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.

Long-term Planning

6. The state should assign specific responsibility for long-term planning to a particular agency or committee.
7. In addition to its current practice of cost accounting, the state should utilize accrual accounting on a selective basis to provide the state's financial policy-makers with long-term planning budget data.
8. The state should centralize information about federal funds in an effort to increase the federal grant dollars it receives.
9. The state should increase the current limit on the budget stabilization fund (the rainy day fund) to its original 15 percent cap and take measures to make 'raids' on the fund more difficult.
10. The state should utilize capital financing tools (bonding) for long-term capital assets with debt service tied to specific revenue streams.
11. The state should establish high-level tax policy guidelines to be used to test the soundness of future proposed transaction privilege tax exemptions.
12. The state should not depend on General Fund revenues to finance new school construction, but instead should implement a process for new school construction using local school district, county or state property taxes.
13. The state should, where possible, phase in major changes – or phase out changes – to the tax structure over time.

Money Management

14. The state should remove the constitutional requirement that raising tax rates requires two-thirds affirmative vote, reverting to a simple majority requirement.
15. The state should hire a consultant to examine the fairness and extent of miscellaneous taxes and fees imposed by the state for services.
16. The state should decrease revenue loss by increasing spending on revenue enforcement until cost-benefit equilibrium is reached, and by implementing a system that makes tax avoidance more difficult.
17. The state should replace unit-based fees and taxes with percentage-based fees and taxes.

18. The state agencies should maximize the 'time-value' of money by increasing interest earnings through the use of frequent deposits, longer-term, higher-interest accounts and other fiscal measures.

Simplicity

19. The state should have as few corporate and personal income tax credits as possible.
20. The state should follow the federal income tax returns as much as possible.
21. The cities and state should pursue greater transaction privilege tax uniformity. The commission recommends taking no formal action to join the streamlined sales tax agreement at this time, but rather to monitor its journey through Congress.
22. Each transaction privilege tax exemption should include a sunset provision to periodically compare the public policy supporting the tax exemption against the evolving state of the state.
23. The state should not adopt a gross receipts or expanded franchise tax as a replacement for the corporate income tax.
24. The state should phase out the homeowner's rebate.
25. The state should not reinstate the 'throwback rule' in the corporate income tax calculation. The throwback rule essentially requires corporations to include as Arizona sales those sales made to places that do not tax the sales.
26. The state should 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 that credit is scheduled to be phased out. The state should not 'decouple'.
27. The state should not adopt a real estate transfer tax.

Diversification

28. Arizona should re-enact the option of a state property tax, applied on a uniform assessment ratio.
29. The state should broaden the transaction privilege tax base by including 'personal' services or 'consumer' services.
30. The state should broaden the transaction privilege tax base by including certain transactions that currently are tax exempt, a private/public review team should be established to examine whether to retain each of the more than 200 statutory exemptions.

Equity

31. The state should withhold income tax from non-residents.
32. The state should retain certain low-income tax credits, including the family tax credit, the increased excise taxes paid credit (Prop. 301 offset) and the property tax credit for low-income seniors.
33. In conjunction with eliminating certain exemptions and broadening the transaction privilege tax base, the state should lower the rate accordingly.
34. The state should eliminate the 1 percent constitutional cap on the residential property tax.
35. The state should review the effectiveness of private school tuition tax credits and the extracurricular public school tax credit.
36. The state should not adopt a single flat tax rate for personal income tax purposes.

A Comparison of FACT Options and CFRC Recommendations

The Citizens Finance Review Commission (CFRC), which did most of its work during 2003, produced a set of 36 recommendations regarding revenue policy in Arizona. Since little action was taken on the CFRC recommendations and conditions since 2003 have not changed appreciably, the CFRC's work remains relevant today.

A key difference between the work of the CFRC and current efforts is that the CFRC explicitly did not address the issue of a structural deficit; that is, it made no recommendations regarding what the level of revenue should be. Instead, it noted that its recommendations would be applicable to a wide range of possible revenue levels. Therefore, the FACT options to increase revenue are not found among the CFRC recommendations, nor are most of the "other options to help reduce near-term deficits."

The following FACT options have some degree of correspondence to CFRC recommendations:

- Options to temporarily raise, then permanently lower, the personal income and/or sales tax rates are included as possible means to avoid the two-thirds requirement for a tax increase. CFRC recommendation #14 is to remove the two-thirds requirement from the Constitution.
- Options to increase taxes on alcoholic beverages and taxes and fees related to vehicle registration include the possibility of indexing these taxes and fees to inflation. CFRC recommendation #17 is to replace unit-based fees and taxes with percentage-based fees and taxes.
- Expanding audits and improving collections was included in CFRC recommendation #16 (increase spending on revenue enforcement).
- Borrowing for capital outlays was considered in CFRC recommendations #10 (use bonding for long-term capital assets) and #12 (General Fund revenue should not be used to finance school construction – property taxes should be used instead).
- The option to create a statewide property tax based on a unified assessment ratio is matched by CFRC recommendation #14.
- The option to modify the operation of the rainy-day fund is matched by CFRC recommendation #9: increase the cap and make raids on the fund more difficult.
- Expanding the sales tax base was addressed in CFRC recommendations #4 (expand the tax base to mirror the state's economy), #11 (establish guidelines to evaluate proposed tax exemptions), #22 (include a sunset provision for all tax exemptions), #29 (broaden the base by including personal services), #30 (broaden the base by including certain tax-exempt transactions), and #33 (in conjunction with eliminating certain exemptions and broadening the base, the rate should be lowered).
- Like the CFRC's recommendation #36, not to adapt a flat tax rate, FACT concludes that a flat tax shifts substantial tax burden to lower income groups. FACT prefers the graduated or a two-level option to the flat tax. Tax simplification can be accomplished under any tax rate structure.

The CFRC made a number of other recommendations that have not been included in the FACT options. Some of these recommendations are narrow or technical in nature. Others, however, might be included among the long-term structural reforms considered by FACT:

- Reducing business property tax burdens was the topic of recommendations #1 and #2.
- Phase out the homeowner’s rebate (#24) and eliminate the 1 percent cap on the residential property tax (#34).
- The reduction of income tax credits was the focus of recommendations #19 and #35 (the latter particularly addressing school tax credits), though the continuation of certain low-income credits is the topic of recommendation #32.
- Examine the extent of miscellaneous taxes and fees (#15).
- Increase federal grants (#8).
- Improvements to long-term planning and money management were included in recommendations #6, #7, and #18.