

INDICATOR INSIGHT

PUBLIC FINANCE ◀•▶ AN EXPERT'S INSIGHT ON THE ISSUE IN ARIZONA

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Public finance—taxes and other revenues collected by government and the expenditure of those revenues—always has been somewhat controversial because of wide philosophical differences among residents regarding the role that government should play in providing public services and in collecting taxes and fees from its residents. Recently, public finance in Arizona has become a prominent public issue due to the need to resolve the deficits that afflict state government and most county and municipal governments in Arizona.

Any examination of public finance must understand the varying levels of data aggregation:

- ▶ **Combined State and Local Governments.** The most comprehensive aggregation is the combination of revenues and expenditures of all state and local (counties, municipalities, school districts, and special districts) governments, as reported by the U.S. Census Bureau. Comparisons to other states need to be made at this level of aggregation, since a particular government function may be provided by the state government in one state but by local governments in another state.
- ▶ **State Government, Total Authorized Spending.** The most comprehensive aggregation reported by the Arizona Joint Legislative Budget Committee for state government is “total authorized spending.” This figure includes monies received from the federal government and from other sources that flow through state government. Total authorized spending by state government is about 60 percent of the total of combined state and local governments. Total authorized spending is rarely used since it is intermediate between the more comprehensive state and local government data reported by the Census Bureau and the data that are specific to the revenues raised directly by state government (and the appropriation of those revenues).
- ▶ **State Government, Total Appropriations.** A third level of aggregation is the total of appropriations made from all of the numerous state government funds. Most of these funds are relatively small, have dedicated funding sources, and are used for specific purposes. Total appropriations from all funds make up less than half of the total authorized spending and less than 30 percent of the total expenditures of combined state and local governments.
- ▶ **State Government, General Fund.** The state government general fund is of considerable interest despite its relatively small size: less than 40 percent of total authorized spending by state government and less than 25 percent of total expenditures by all state and local governments. Revenues deposited in the state government general fund are appropriated by the Arizona Legislature for a variety of purposes, most notably education, corrections, and public health and welfare programs. The general fund accounts for three-fourths of the total appropriations of the state government. The Legislature has more discretion over the general fund than other funds and the general fund is the primary source of funding for elementary and secondary education. The general fund also receives considerable attention because of its frequently large annual surpluses and deficits.

In order to compare government finance data over time, the data must be standardized for inflation, population growth, and real per capita economic growth. This is best accomplished by expressing the public finance data per \$1,000 of personal income.



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Arizona Indicators is an online information resource and analysis tool that centralizes data about the state and its communities. Arizona Indicators presents interactive visualizations, clear data descriptions, and public opinion data in a broad range of content areas.

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State Government General Fund

State government general fund revenues per \$1,000 of personal income have fallen considerably since the early 1990s. The effects of multiple tax cuts, particularly to the personal income tax, are seen in figure 1. The adjusted revenue line shows the revenues that would have been realized had no changes to the tax code been made.

Government revenues are cyclical, going up and down with the economic cycle, with the revenue fluctuations greater than those of the overall economy. Since the early 1990s, general fund revenues have become much more cyclical than in earlier years. Capital gains are one reason for the increase in cyclicity of general fund revenues. The stock market boom in the 1990s and the subsequent decline, and the real estate boom in the mid-2000s followed by a crash, increased the volatility of capital gains, contributing significantly to wide swings in government revenues.

The other cause of the increased cyclicity in general fund revenues is that the multiple tax cuts implemented since the early 1990s substantially narrowed the tax base used for the general fund, making the general fund more reliant on fewer and volatile sources of revenue. For example, the general fund no longer receives revenue from vehicle license taxes, a stable source of revenue over the economic cycle. General fund revenue from the property tax also was eliminated. In addition, various exemptions to the sales tax were implemented and a variety of tax credits were made available.

The cyclicity of revenues was enormous in the last economic cycle—a cyclical surplus of \$1.7 billion in fiscal year 2007 became a cyclical deficit of the same magnitude three years later. The cyclicity of revenues is particularly significant because of the lack of cyclicity in demand for public services. Children, for example, do not stop going to school during a recession. In fact, demand for public health and welfare programs rises during recessions as people lose their jobs or suffer reductions in hours worked or hourly wages.

Since the Arizona Constitution requires a balanced budget, cyclical reductions in revenues mean that expenditures also must fall unless the lost revenues are offset. Many one-time adjustments to revenues—including transfers to the general fund from other funds and the sale-leaseback of state-owned properties—were made during the last two recessions, but these sources were inadequate to fully offset the loss of revenues. With the Arizona Legislature unwilling to raise revenues, even temporarily, the result was significant reductions in public spending during the last two recessions, as seen in figure 2—despite an increase in demand for public services during each recession.

In addition to the significant cyclicity of revenues and expenditures, figure 2 illustrates that each has been trending down

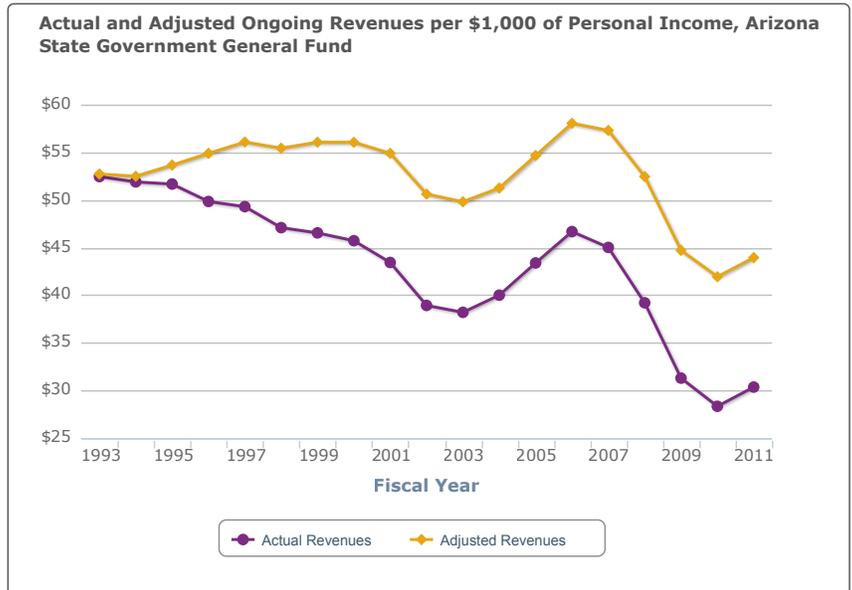


Figure 1 - Actual and Adjusted Ongoing Revenues per \$1,000 of Personal Income, Arizona State Government General Fund. Sources: Arizona Joint Legislative Budget Committee (revenues and effects of tax law changes) and the U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

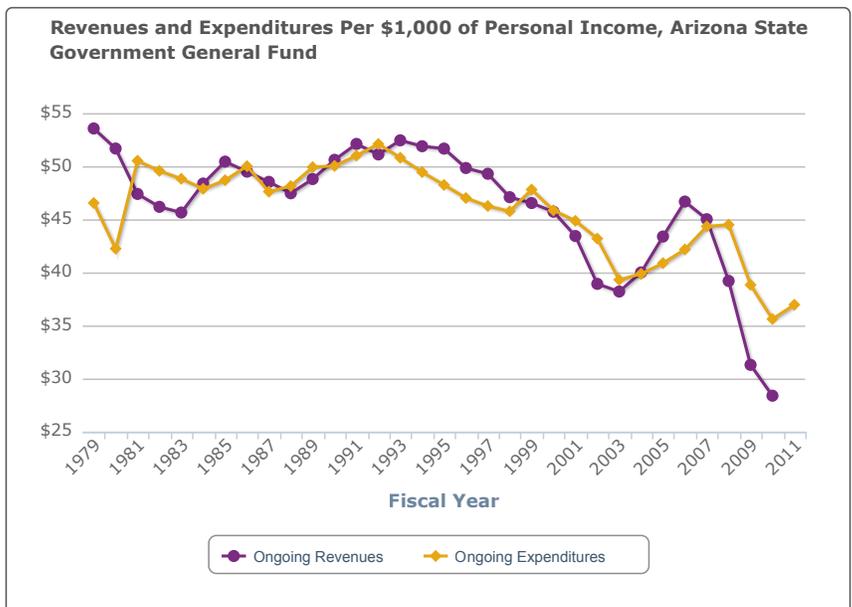


Figure 2 - Revenues and Expenditures Per \$1,000 of Personal Income, Arizona State Government General Fund. Sources: Arizona Joint Legislative Budget Committee (revenues and expenditures) and the U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

since the early 1990s relative to the size of the Arizona economy and the ability of Arizonans to pay taxes and fees. The downtrend in revenues is predominantly the result of numerous and large reductions in tax rates and tax bases since the early 1990s that have resulted in a loss of nearly \$3 billion in revenues. Expenditures also were reduced through fiscal year 2008, but not by as much as revenues, leaving a structural deficit of just more than \$2 billion that is in addition to the cyclical deficit.

Since fiscal year 2008, very large spending reductions have been made in order to balance the budget. In the estimates of the structural deficit in figure 3, these recent reductions in expenditures are assumed not to be permanent. If they prove to be permanent, then the structural deficit has largely been eliminated. This would mean that general fund spending per \$1,000 of personal income would remain some 25 percent below the historical average.

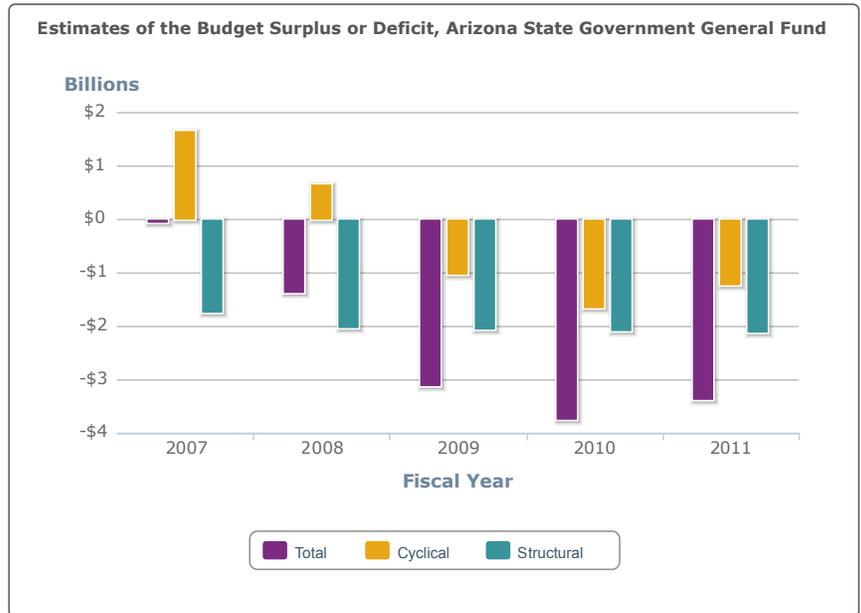


Figure 3 - Estimates of the Budget Surplus or Deficit, Arizona State Government General Fund. Source: Center for Competitiveness and Prosperity Research, W. P. Carey School of Business, Arizona State University from Arizona Joint Legislative Budget Committee data.

Combined State and Local Government Finance

With the state general fund accounting for less than one-fourth of total finances of state and local governments in Arizona, it is conceivable that general fund reductions in revenues and expenditures have been offset elsewhere in state government or by local governments. The latest data from the Census Bureau on combined state and local government finance are for fiscal year 2008. The peak of the economic cycle occurred during this year, following years of unusually strong economic growth driven by the real estate boom. Thus, the last couple of years of Census Bureau data are unrepresentative. Since then, state and local government revenues have fallen considerably, accompanied by reductions in expenditures.

Before this cyclical high, own-source state and local government revenues relative to the size of the economy were at least 10 percent lower during the 2000s than in the early 1990s. In the early 1990s, own-source revenues in Arizona relative to the size of the economy were at or slightly above the national average, ranking higher than the median state. Since fiscal year 1996, own-source revenues relative to the size of the economy have ranged from 5 to 10 percent below average; Arizona has ranked no higher than 14th lowest.

Similarly, noncapital expenditures dropped during the 1990s relative to the size of the Arizona economy. Noncapital expenditures ranked near the median state in the early 1990s, but have been lower since then. Since the late 1990s, except at the cyclical peak, noncapital expenditures relative to the size of the economy were about 10 percent below the national average in Arizona. The differential is almost certainly substantially larger today. Thus, the large decreases in general fund revenues and expenditures since the early 1990s have resulted in reduced figures for all of state and local government.

Estimates of the tax burden are another way of comparing Arizona to other states. One study, which uses different data and methods than the Census Bureau, estimates the household tax burden at each of five income levels in largest city in each state, plus the District of Columbia. As seen in figure 4 (next page), the overall tax burden in Phoenix is about 20 percent below the median city at each of the four highest income levels (some of the data are not reliable at the lowest income level). At all income levels, the sales tax burden is 70-to-80 percent above the median in Phoenix—the highest among the 51 cities. In contrast, the property tax burden and personal income tax burden each is only half of the median of the 51 cities.

In contrast, the business tax burden in Arizona is only slightly less than the national average. The two primary sources of revenue—the sales tax and the property tax—are above the national average, with the sales tax burden more than 50 percent above average. All other business tax burdens are considerably below average, as seen in figure 5 (next page). Furthest below average is the individual income tax, which is used by owners of small businesses.

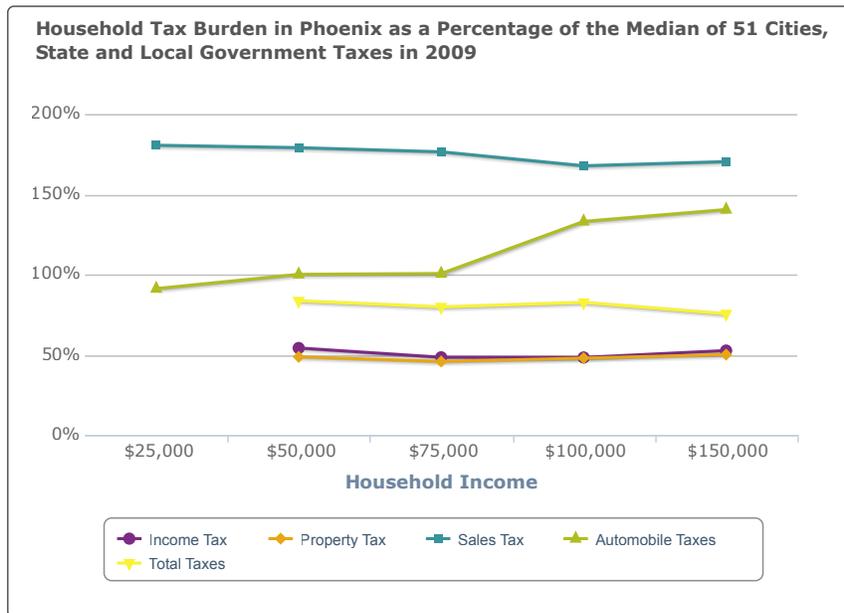


Figure 4 - Household Tax Burden in Phoenix as a Percentage of the Median of 51 Cities, State and Local Government Taxes in 2009. Source: Government of the District of Columbia.

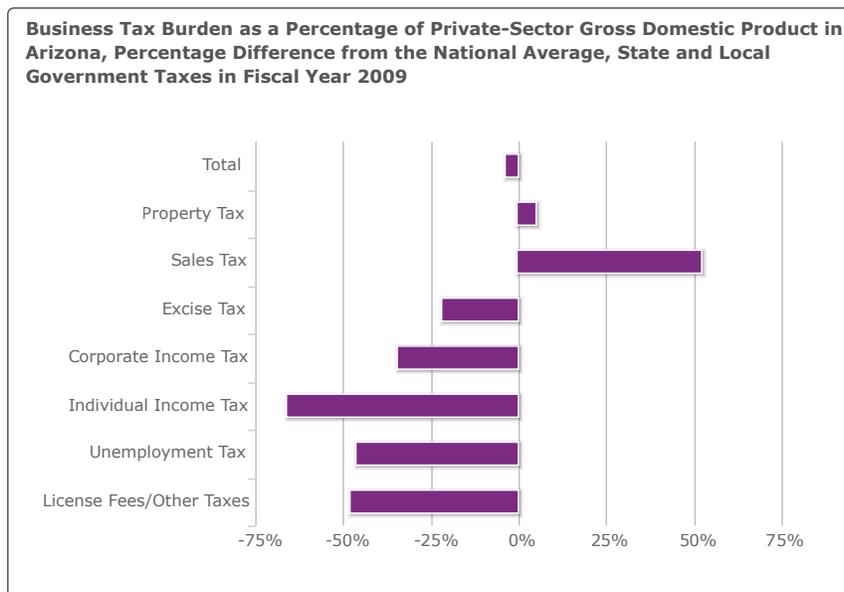


Figure 5 - Business Tax Burden as a Percentage of Private-Sector Gross Domestic Product in Arizona, Percentage Difference from the National Average, State and Local Government Taxes in Fiscal Year 2009. Source: Ernst & Young and the Council on State Taxation.