

POLICY POINTS

➤ POLICY POINTS BRINGS RELEVANT DATA TO TIMELY PUBLIC POLICY ISSUES IN ARIZONA

A Question that Arizonans Need to Answer

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For more than half a century after statehood in 1912, Arizonans were willing to accept a relatively high state and local government tax burden, with a disproportionate share of the revenue used to support public education. This was in line with the Arizona Constitution, which mandated that “the legislature shall make such appropriations, to be met by taxation, as shall insure the proper maintenance of all state educational institutions, and shall make such special appropriations as shall provide for their development and improvement.”

Though the Constitution was never modified, support for public education began to wane in the late 1960s. Along with a reduction in education spending relative to the rest of the nation, the tax burden of Arizonans fell. Until this time, the educational attainment of Arizonans was better than the national average. High-technology operations accounted for a larger share of the Arizona economy than the national economy. Incomes of Arizonans were relatively close to the national average.

As late as the early 1990s, the state and local government tax burden in Arizona was near the national average but support for education had tailed off to below the national norm. Since the early 1990s, a long series of tax cuts have dropped Arizona’s tax burden to among the bottom ten states. Funding per student at elementary and secondary schools currently is nearly the lowest in the country and higher education funding per student also ranks among the bottom 10 states.

Now, the educational achievement and attainment of Arizonans is below average. The high-tech sector is shrinking and no longer is a larger share of the Arizona economy than the national economy. Incomes have fallen significantly to 16 percent below the national average. The low taxes have hardly resulted in a healthy and growing economy. Arizona’s economic performance has been near the bottom of the states in recent years.

Despite all of the spending reductions (which have included significant reductions in spending for education), fund transfers, and other techniques used to balance the budget in the preceding few years, the state government general fund faces a deficit projected at several hundred million dollars in the current fiscal year (which ends June 30, 2011) and an additional \$1 billion or more in the next fiscal year: roughly \$2 billion in total. Temporary fixes have been largely exhausted, so closing the deficits in the next legislative session will require additional spending cuts, with education a target. Thus, this is an opportune time to ask the following question of all Arizonans:

Are you content with the historically low expenditures currently being made from the general fund and satisfied that the current low level of public services will be permanent?

If Arizonans respond negatively to this question, they need to realize that there is only one alternative: raising revenues permanently, which must translate to higher taxes on individuals. There is no magic bullet to resolving the fiscal issue: people with the ability to pay must pay for what they want.

Arizonans have been led to believe that huge “waste” is still left in state government. “Wasteful” is defined as “using more than is necessary,” but various studies that have been conducted since the Symington administration have failed to find much “waste” in state government. Instead, “waste” seems to be defined as public programs not favored by certain individuals. To the extent that government inefficiency (true “waste”) exists, it is puny compared to the size of the deficit.



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Education, corrections, and health and welfare are partially exempt from spending cuts because some level of public service/public funding is mandated in the Arizona Constitution. If ALL of state government other than these programs was TOTALLY eliminated, the general fund savings would be only \$500 million. Thus, eliminating “waste” will not come remotely close to resolving the remaining budget deficit.

Resolving the deficit only through spending reductions requires that constitutionally mandated programs also receive further substantial cuts. The elimination of ALL general fund appropriations for higher education would only save \$1 billion. If the ENTIRE correctional system was eliminated, the savings would be \$1 billion. Though K-12 education was appropriated \$3.5 billion from the general fund in the current fiscal year, even modest further reductions will likely ensure that Arizona is the state least willing to support education. General fund appropriations also are substantial for public health and welfare programs (\$1.4 billion for AHCCCS—Arizona’s alternative to Medicaid—and \$1.1 billion combined for the Department of Health Services and the Department of Economic Security), but a substantial reduction in state funding would mean the loss of billions of dollars in federal matching funds—which would devastate a still weak Arizona economy.

The Origins of the Problem

A natural question to ask is “how did state government finances become such a mess?” Many causes can be identified. The long and severe recession, which has resulted in a large decline in revenues, has contributed significantly. Still, even after revenues rise with the recovering economy, a significant problem will remain. At the core of the fiscal problem are numerous legislative (and voter) decisions made since the early 1990s. One of these was to underfund the rainy-day fund.

One major cause of the fiscal dilemma is that spending obligations have been added to the general fund without a funding source. Two stand out. First, in response to a lawsuit, the Legislature decided to move funding for school construction into the general fund, effective in fiscal year 1999, with expenditures reaching nearly \$500 million in some years. Second, two competing voter initiatives to expand AHCCCS (the Arizona Health Care Cost Containment System) were on the 2000 ballot. Each specified the same funding source. When both passed, the funding for the second initiative had to come from the general fund.

The largest cause of the fiscal problem is the permanent reduction in taxes that have been passed at times of a temporary budget surplus. The numerous tax cuts since the early 1990s have accumulated to nearly \$3 billion (after adjusting for inflation, population growth, and economic growth). This is more than one-third of the current budget. As should be obvious from the poor performance of the Arizona economy in recent years, tax cuts do not equate to a stronger economy and increased government revenues (except under very specific conditions that largely are not present in Arizona). Thus, to balance the budget on an ongoing basis, any tax cuts that are passed must be matched by spending cuts of a commensurate size. Arizona is still reducing spending to match the earlier tax reductions.

Revenues

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.

Relative to the size of the economy and the ability of Arizonans to pay taxes and fees—even at the end of a long and deep recession—Arizonans currently are contributing far less revenue to support general fund operations than at any time in the 40 years that data are available, as seen in figure 1. The adjusted revenue line on the chart illustrates the revenues that would have been raised had no changes to the tax code occurred since the early 1990s.

Much of the decline in revenues since fiscal year 2007 results from the long and deep economic

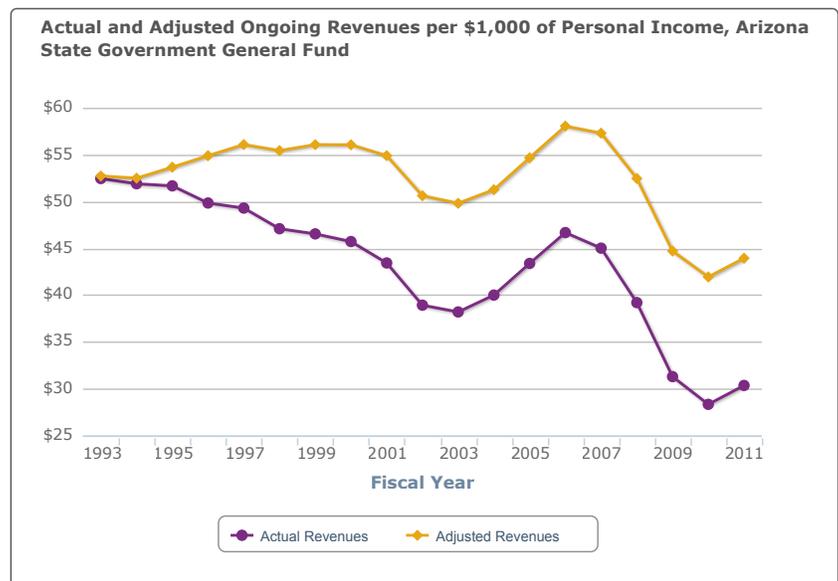


Figure 1: Actual and Adjusted Ongoing Revenues Per \$1,000 of Personal Income, Arizona State Government General Fund. Sources: Arizona Joint Legislative Budget Committee (revenues and effects of tax law changes) and the U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

recession. Revenues will rise as the economy improves, but a full recovery from the recession is still some years off. Even then, due to the tax cuts, revenues relative to the size of the economy and the ability of Arizonans to pay will be substantially below the historical norm.

Rising revenues will not necessarily result in a restoration of the some of the spending cut in the last few years. The competing uses for the surplus revenues—which will last only a few years until the next economic downturn—are numerous. Foremost among these is the need to rebuild the rainy-day fund. Far more money needs to be placed in this fund than in the past in order for the fund to perform as designed: to offset the decline in revenues that occurs during an economic downturn. Very substantial monies also have been transferred from many other state funds into the general fund. If reverse transfers are not made to those funds, they will not have the resources to adequately provide the public service for which they were created.

As a result of all of the tax cuts, the total tax burden—of all state and local government taxes—has fallen substantially in Arizona. According to the Tax Foundation, the tax burden in Arizona was slightly above the national average in the late 1970s and only a little below average in the early 1990s, but had fallen to 12 percent below the national average by 2008, ranking 41st among the states.

Most of the tax cuts benefitted individuals rather than businesses. Using 2009 data, the Government of the District of Columbia found that the individual tax burden in Phoenix was approximately 20 percent below the median of the largest cities in each state and the District of Columbia. In contrast, the business tax burden averages only a little below the national average. For some businesses, the tax burden is comparatively low, but for others—including large high-technology firms that pay high wages—the tax burden in Arizona is above average.

Expenditures

As tax cuts were implemented between fiscal years 1993 and 2008, spending also was reduced, but not by nearly as much as revenues. This created a structural deficit of a little more than \$2 billion in fiscal year 2008. General fund expenditures have fallen substantially since then, largely eliminating the structural deficit—assuming that the spending reductions are permanent. Yet expenditures in the near term remain higher than revenues, as seen in figure 2. Revenues are highly cyclical, but public needs are not cyclical. In fact, demand for public health and welfare programs is countercyclical, rising at the same time that revenues are falling.

Budget cuts to the correctional system have been modest. Unlike nearly every other state program, appropriations from the general fund in the current fiscal year are higher than in fiscal year 2008. Correctional expenses have increased over the last 30 years due to the huge increase in the number incarcerated, a result of the mandatory sentencing laws first implemented in the late 1970s. Before that, correctional spending in Arizona relative to the size of the economy was near the national norm. According to the latest Census Bureau data, correctional expenditures in Arizona are among the highest in the nation. Recent calls to review the mandatory sentencing system are being ignored by the Legislature.

Eligibility for public health and welfare programs has been tightened; individuals who previously qualified for assistance are being rejected. Payments to needy individuals have not kept pace with inflation. However, these cost controls have been overwhelmed by the recession-driven huge increase in demand for these programs. The general fund accounts for only a small share of the funding for these programs. Funding also is provided by other state funds, but the main source is the federal government. Total health and welfare funding in Arizona relative to the size of the economy has been considerably below the national average.

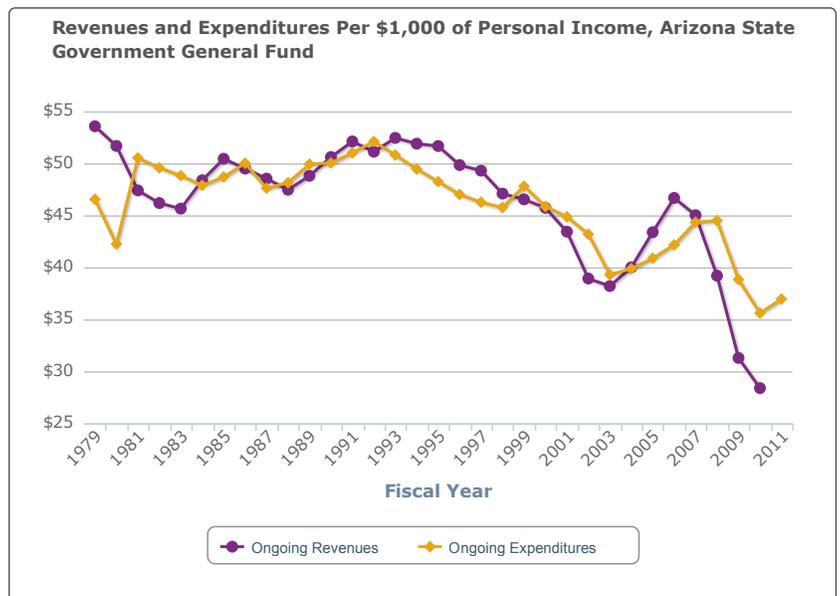


Figure 2: Revenues and Expenditures Per \$1,000 of Personal Income, Arizona State Government General Fund. Sources: Arizona Joint Legislative Budget Committee (revenues and expenditures) and the U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

With education accounting for more than half of the general fund, any significant reduction in general fund spending has to impact education. Thus, a desire for low taxes effectively equates to a desire for low spending on education. Total K-12 funding from all sources has declined over time relative to the rest of the United States, with the per pupil figure dropping from above the U.S. average during the 1960s to 10 percent below average during the 1980s to 30 percent below average in recent years. Decreases also have occurred for higher education, with total funding per full-time-equivalent student falling from slightly above the national average in the mid-1980s to about 15 percent below average in recent years. The recent decreases in general fund appropriations for universities have resulted in huge increases in tuition, even though the Arizona Constitution states that education should be “as nearly free as possible.” The funding decreases over time and the low rank among the states raise serious questions whether the Arizona constitutional mandate for the Legislature to maintain and improve education is being met.

Consequences of Low Public Funding

In the near term, those most affected by low public funding are the individuals most in need, many of whom have turned to public support only because of factors out of their control: the ravages of the longest and deepest recession since the Great Depression. However, low public funding has numerous consequences that affect all Arizonans, from traffic congestion to fighting crime to breathing clean air, etc. Thus, low public funding reduces the quality of life.

Perhaps most significantly, low public funding affects the economic well-being of residents by reducing the ability of the state to compete economically. Already, the state does not compare as favorably as it did years ago in terms of incomes and the percentage of higher-wage jobs. Recent spending reductions likely will result in further declines.

Of most importance to employers is the ability to hire a qualified workforce. Especially for employers that offer high wages, the poor educational achievement and attainment of Arizonans is a significant deterrent to locating/expanding in Arizona. Employers also need a strong physical infrastructure. Even before the recent budget crunch, Arizona was lagging behind on its transportation system and other physical infrastructures.