



FINANCING ARIZONA'S FUTURE

NOVEMBER 2016

Background Report for the 109TH ARIZONA TOWN HALL

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Whether you care about education, our criminal justice system or the roads that get you to work, all of these issues are impacted by government revenue and spending. Government finance is critical to all other issues that involve Arizona's local and state government systems.

We thank you for making the commitment to participate in the 109th Arizona Town Hall to be held at the Hilton Phoenix/Mesa on November 13-16, 2016. You will be discussing and developing consensus on the topic of "Financing Arizona's Future."

An essential element to the success of these consensus-driven discussions is this background report that is provided to all participants before the Town Hall convenes. The Morrison Institute at Arizona State University coordinated this informative background material in partnership with other industry professionals who have lent their time and talent to this effort. Together they have created a unique resource for a full understanding of the topic.

For sharing their wealth of knowledge and professional talents, our thanks go to the report's authors. Our deepest gratitude also goes to Tom Rex, Associate Director, Center for Competitiveness and Prosperity Research, Manager of Research Initiatives, Office of the University Economist, L. William Seidman Research Institute, W. P. Carey School of Business, Arizona State University, who marshaled authors, created content and served as editor of the report.

The 109th Town Hall could not occur without the financial assistance of our generous Professional Partners, which (at the time of this printing) include Premier Partner Arizona Public Service (APS); Consensus Partner Salt River Project (SRP); Civic Leader Partner Bank of America; and Contributor Partner Arizona Fire District Association.

When the 109th Town Hall ends, the background report will be combined with the recommendations from the Town Hall into a final report. This final report will be available to the public on the Arizona Town Hall website and will be widely distributed and promoted throughout Arizona. The Town Hall's report of recommendations and background report will be used as a resource, a discussion guide and an action plan on how best to finance Arizona's future.

Sincerely,

Linda Elliott-Nelson
Board Chair, Arizona Town Hall
www.aztownhall.org

FINANCING ARIZONA'S FUTURE

NOVEMBER 2016

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INTRODUCTION

Seven previous Arizona Town Halls have addressed government revenue and/or government expenditures, most recently in Fall 2009. The background report to the Fall 2009 Town Hall was far ranging and remains timely.¹ The fall 2009 Town Hall resulted in a number of recommendations. While short-term recommendations were implemented into law, hardly any progress has been made on those recommendations that were labeled as “long-term actions.”²

This background report is shorter, focusing on providing up-to-date data. For readers who would like more information on a particular topic than is provided in this report, numerous references to the 2009 Town Hall report and to other recent reports are included.

Arizona state government’s general fund is the focus of this report due to the significant cyclicity of its revenue and its frequent deficits. However, the general fund cannot be analyzed in isolation. Many state government programs receive funding from both the general fund and other sources, including other state funds and the federal government. Further, state government shares some revenue with local governments. The responsibility for some public programs may be shared by various levels of government, or may shift over time between federal, state, and local governments. Thus, in addition to the general fund, other state government funds, monies authorized but not appropriated by state government (such as those originating from the federal government), and local government finance also are addressed in this background report.

A challenge to government finance at all levels and in all places is that government revenue is pro-cyclical — it goes up and down in unison with the economic cycle — while the demand for government services is not pro-cyclical and in some cases is counter-cyclical. For example, enrollment in public assistance programs rises when economic growth and government revenue falters. As a result of these unmatched cycles in revenue collection and the demand for expenditures, governments experience cyclical surpluses when economic growth is strong and cyclical deficits during economic recessions.

Since governments in Arizona are prohibited from carrying a deficit forward into succeeding years (see Article 9, Section 3 of the Arizona Constitution), and since the state property tax that historically was used to balance the budget has been eliminated, difficult decisions must be made during times of economic weakness in order to annually balance revenues and expenditures. To reduce the challenge of balancing the budget, a budget stabilization fund (BSF or “rainy-day” fund) was created by state government in 1990. The intent was to transfer monies from the general fund into the BSF during years of budget surpluses and then to transfer monies from the BSF into the general fund to resolve budget deficits. However, the original statutory language governing the rainy-day fund was subsequently weakened and changes in the tax laws after the creation of the BSF increased

¹ Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

² Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Recommendations Report, pages 12-14, November 2009, http://www.aztownhall.org/Resources/Documents/95th_Recommendations.pdf.

revenue cyclical. As a result, the BSF had substantially inadequate monies to balance the budget during each of the two economic recessions that have occurred since its creation.

Thus, despite the presence of the BSF, significant deficits have remained during periods of economic weakness. One or more of three fundamental options may be used to balance the general fund: increase revenue, decrease spending, and utilize one-time “budget solutions.” Increasing revenue or reducing spending has a short-term negative impact on the state’s economy, worsening the economic recession. Budget solutions include transferring monies into the general fund from other funds and deferring payments until the next fiscal year.

In addition to periodic cyclical deficits, Arizona state government’s general fund has experienced a structural deficit for much of the last 40 years. A structural deficit is an imbalance between revenues and expenditures independent from cyclical factors. It is caused either by choosing to increase spending without a commensurate increase in revenue or by opting to reduce revenue without a commensurate decrease in spending. Most of the structural deficits in the general fund over the last several decades have been caused by tax cuts not accompanied by corresponding reductions in spending. Changes to the tax code since the early 1990s — most of which have reduced tax rates or narrowed the tax base — resulted in the loss of general fund revenue of a little more than \$4 billion in fiscal year 2016.

Tax reductions generally have been passed during years of cyclical surpluses that resulted from strong economic growth. Thus, the tax cuts could be implemented without reducing expenditures, while still balancing the budget in the near term. Occasionally, implementation of tax reductions has been delayed until economic growth has been projected to be stronger. Either way, spending reductions commensurate with the tax cuts did not need to be made — and were not made — when tax reductions were passed, creating a structural deficit. When economic growth slowed, the cyclical surplus that had masked the structural deficit turned into a cyclical deficit. Thus, the already significant challenge of resolving a cyclical deficit was complicated by a structural deficit.

Each of the last two economic recessions — in 2001 and from 2008 into 2010 — were followed by a slow economic recovery, leading to an extended period of significant deficits in the general fund. One-time budget solutions were heavily used during each recession. These one-time budget solutions are effective remedies to the cyclical deficit but the use of such solutions is limited and has negative effects. Further, these solutions have no impact on the structural deficit. Large spending reductions also were implemented during and shortly after each recession — at the worst possible time from the perspectives of the economy and the needs of Arizona’s residents. Despite these spending cuts, the structural deficit was not eliminated.

The heavy use of spending reductions in the last two recessions is in contrast to the prior recession in the late 1980s-early 1990s, when both spending reductions and revenue increases were implemented. Increasing revenue became more difficult in 1992, when a voter-passed initiative amended the Arizona Constitution (Article 9, Section 22) to require a two-thirds majority vote of the Legislature to increase revenue.

In addition to reducing revenue, the numerous changes made to tax laws have resulted in a significant narrowing of the tax base used for the general fund, which is now highly dependent on sales and income taxes. Revenue from each of these sources is highly cyclical. Further, the sales tax base largely is limited to goods purchased in stores, while consumer purchases are shifting to untaxed services and to goods purchased via the Internet. Thus, sales tax revenue is not keeping pace with the growth of the state.

I. INTRODUCTION TO GOVERNMENT FINANCE IN ARIZONA

- More than one-third of the revenue received by Arizona state government comes from the federal government. Similarly, more than one-third of the revenue realized by local governments in Arizona derives from either the federal government or the state government — primarily the latter.
- The general fund is by far the largest of the more than 200 funds used by Arizona state government. Its revenue comes from multiple sources, though primarily from the state sales tax and the state income tax. The uses of this revenue are numerous.
- In contrast, most of the other funds receive revenue from just one or a few specific sources. This revenue is used for specific purposes.
- Less than 40 percent of the total authorized spending of the Arizona state government is appropriated by the Legislature; the appropriations largely consist of tax revenues. The monies that are not appropriated mostly come from user fees and the federal government and must be used for specific purposes.
- State government consists of more than 100 agencies. An agency may receive funding from one or more of the three categories of the general fund, other funds, and not-appropriated monies.

Government finance data — revenues and expenditures — are reported on a fiscal year (FY) basis. For example, for Arizona and most of the other states, fiscal year 2017 runs from July 1, 2016 through June 30, 2017.

The U.S. Census Bureau provides data on state government finance, local government finance, and combined state and local government finance, though the latest data are for fiscal year 2013.³ Data are available online for fiscal years 1992 through 2013, though no data were collected for local governments in FYs 2001 and 2003. For some categories of revenues and expenditures, the earliest data are for FY 1993.

States may be compared using the Census Bureau's data, since the Census Bureau translates the unique accounting systems used in each state into one consistent system. Since the division of taxing authority and program responsibilities between state governments and local governments varies by state, government finance comparisons across states are based on combined state and local government data.

More detailed data on Arizona state government finance are available from the Arizona Joint Legislative Budget Committee (JLBC).⁴ These data cannot be compared to other states. The JLBC organizes state expenditures into three categories: appropriations from the general fund, appropriations from other funds, and not-appropriated monies. The JLBC provides a time series of general fund revenue by source from fiscal years 1971 through 2016; the data for FY 2016 are preliminary. Appropriations by agency are available from FYs 1979 through 2017 for the general fund. The aggregate of appropriations from other funds, and not-appropriated monies, are available by agency for FYs 1989 through 2017.

³ U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/>.

⁴ Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm>.

The analysis in this background report focuses on the latest data available and on the change over time using two time periods: since FY 1992 and since FY 2007. Fiscal year 1992 was selected for two reasons:⁵

- An economic recession ended during fiscal year 1992.
- A structural deficit that had been present throughout the 1980s essentially had been resolved through a combination of tax increases and spending reductions enacted between fiscal years 1989 and 1991. However, a series of tax reductions began in FY 1993, creating a new structural deficit.

Fiscal year 2007 was selected to provide a more recent perspective; a long and deep recession began in FY 2008.

In order to fully understand government finance in Arizona, the federal government, state government, and local governments need to be considered. State and local governments receive considerable funding from the federal government. Local governments receive substantial funding from revenue collected by the state government.

To illustrate the interrelationships between governments, the Census Bureau reports that Arizona state government received 36.3 percent of its general revenue in FY 2013 from other governments, predominantly the federal government. Local governments in Arizona received a similar share (36.5 percent) of their general revenue from other governments, with 32.1 percent from state government and 4.4 percent from the federal government.⁶

State Government Funds and Agencies

In the JLBC's accounting system, state government finance is divided into more than 200 funds. Appropriations from the general fund in FY 2017 are 2.6 times as large as appropriations from all other funds combined. Ninety percent of the revenue for the general fund comes from the sales tax and the income tax.⁷ There are many uses for general fund revenue. In contrast, the other funds are much narrower in scope. In each of these other funds, revenue comes from one or a few specific sources, including taxes and user fees, and is used for specific purposes.

Appropriations account for only 37 percent of the total authorized spending of state government in FY 2017. The monies that are not appropriated largely come from user fees and from the federal government and must be used for specific purposes. For example, tuition and fees received from public university students are placed in a separate fund and must be used for university operations. Most, but not all, of the tax revenue collected by the state is appropriated; a small portion of the federal government monies are appropriated.

There are more than 100 budget units (state agencies). Any particular agency may receive funding from one or more of the three categories (general fund, other funds, and not-appropriated monies). A number of agencies receive funding from more than one of the funds other than the general fund. Many of the other funds are used by just one agency, but the monies from some funds go to more than one agency. The first box on page 6 provides insight into the accounting system used by the JLBC.

⁵ Since the earliest fiscal year for which data are available for all Census Bureau categories is 1993, the time series analysis of Census Bureau data is for the period between FYs 1993 and 2013.

⁶ Local governments include counties, municipalities, school districts, and special districts.

⁷ In Arizona, the general sales tax is officially called a transaction privilege tax.

State Government Budgeting Process

Early in each regular legislative session, which begins each January, the Governor's Office of Strategic Planning and Budgeting releases a budget proposal for the next fiscal year. Revenue projections and recommended funding levels by agency are included. The second box on the next page discusses the process of putting together the budget.

The legislative branch follows a parallel process. The JLBC prepares a "baseline book" each January that includes revenue projections and "baseline funding" by agency. Baseline funding is the funding for the prior year adjusted by any active funding formulas. (For example, an increase in the number of elementary and secondary school students results in a boost in funding.) The baseline book includes all state government funds as well as not-appropriated expenditures. The Legislature considers the JLBC baseline book as well as the Governor's budget in deciding on projected revenue and on funding levels for each agency in the upcoming fiscal year. Funding decisions jointly consider the general fund, other funds, and not-appropriated monies.

Once the Legislature has passed a budget and the budget has been signed by the Governor, the JLBC prepares the annual *Appropriations Report*, which is similar in format to the baseline book. It is available several weeks after the budget has been passed.

Comparisons of Government Finance Data

When government revenues and expenditures are compared either over time or across states, an adjustment must be made for differences in size. When the comparison is of totals, or of programs that serve the entire population, the adjustment can be made in either of two ways:

- Divide the finance data by population, putting the figures on a per person (per capita) basis.
 - For comparisons over time, inflation also must be considered. Generally, the gross domestic product (GDP) implicit price deflator is used as the inflation measure, though the Consumer Price Index sometimes is used.
 - For comparisons across states, interstate differences in the cost of living also should be considered.
- Divide the finance data by personal income; the result generally is expressed per \$1,000 of personal income. Occasionally, gross domestic product is used instead of personal income.^{8,9}

⁸ GDP, the GDP deflator, personal income, population, and the cost of living — as measured by regional price parities — are available from the website of the U.S. Department of Commerce, Bureau of Economic Analysis (BEA): <http://www.bea.gov/>. Regional price parity estimates are only available for the 2008-through-2014 period. Arizona's cost of living has not been much different from the national average, ranging from 0.6 percent above average in 2008 to 3.6 percent below average in 2014.

⁹ Data for all of FY 2016 are not yet available from the BEA. The FY 2016 figures (e.g. for personal income) are estimated from the quarterly data that have been released. The FY 2017 population and personal income figures used to adjust appropriations for the current fiscal year are projections.

Beyond the General Fund: Arizona's Appropriated and Non-Appropriated Funds

Stefan Shepherd, Deputy Director, Arizona Joint Legislative Budget Committee

The most important fund source for Arizona state government is the state general fund. General fund revenue comes from a variety of sources, but primarily from the state's share of transaction privilege taxes, individual income taxes, and corporate income taxes. In addition to the state general fund, the state has hundreds of other funds with their own separate fund source. Some of these other state funds, such as the funds administered by regulatory agencies, receive their revenues from user fees. Other sources of funds include dedicated taxes (e.g., gasoline tax, most cigarette taxes), criminal penalties, and other state funds for providing services to state agencies.

An "appropriation" is authorization by the Legislature for a state agency to spend a certain amount of money from a specified fund in a fiscal year for a specific purpose. The state general fund is an appropriated fund. The Legislature also appropriates some, but not all, other state funds. While the appropriation authorizes an agency to spend money, an agency cannot spend more money than is available in a fund, which can also serve as a limit on agency spending.

Some funds are designated in Arizona statute as "continuously appropriated" or "non-appropriated" funds. In contrast with appropriated funds, agencies have discretion over their level of spending from these non-appropriated funds, limited by statutory requirements and available monies in the funds. With a few exceptions, the Legislature does not appropriate federal funds; as with state non-appropriated funds, agencies' discretion over the federal non-appropriated funds may be limited by federal regulations and available monies.

Executive Branch Budget Process

Bret Cloninger, Assistant Director, Office of Strategic Planning and Budgeting

The budget cycle for many state agencies begins as much as a year and a half before the beginning of the year in question, when agency management and staff begin to evaluate agency budget needs. After reviewing, prioritizing, and finalizing the package of requested budget changes, agencies submit their budget requests to the Governor's Office of Strategic Planning and Budgeting (OSPB) and the Joint Legislative Budget Committee (JLBC) staff on September 1, ten months before the beginning of the year being budgeted.

On the executive side, OSPB analysts evaluate the agency expenditure requests during the fall, with the goal of producing defensible budget recommendations for evaluation by OSPB management and, ultimately, the Governor. General fund revenue estimates for the executive branch are the result of economic models combined with the experience and understanding of economists at the Department of Revenue, the Seidman Research Institute at the Arizona State University, OSPB, and other outside consultants.

Staying within available revenues and taking into account the Governor's priorities, the Executive Budget Recommendation is released during the first week of the legislative session in January. The executive recommendation proposes changes in agency budgets for both the state general fund and other legislatively appropriated funds, and also lists projected revenues and recommended expenditures for funds that are not subject to legislative appropriation.

During the legislative session, the Governor's Office and both houses of the Legislature negotiate a budget agreement that is acceptable to all parties. Once passed by the Legislature and signed by the Governor, state agencies load the enacted budget into the state accounting system in preparation for implementing the budget in the new fiscal year starting on July 1.

Generally, the personal income adjustment is preferred for revenue data — both comparisons over time and across states — since personal income reflects the ability of residents to pay taxes and user fees. The change in expenditures over time often uses the personal income adjustment.

However, for comparisons of expenditures across geographic areas for a given year, the per person adjustment may be preferred, assuming that adjustments for the cost of living also are made. After adjusting for the cost of living, the cost of providing a public service is similar across states. If the ability to pay is considered, then a low-income state like Arizona would spend less than average, either providing an inferior public service, or limiting the number of people it serves. For public programs such as education and infrastructure, an inferior or limited service has a negative effect on economic development.¹⁰

When the comparison is of programs that serve only a portion of the population — such as elementary and secondary school students or inmates in the correctional system — then the preferred method is to adjust by the caseload — the number of people served. If the caseload is used, comparisons over time must adjust for inflation and geographic comparisons should consider the cost of living. If desired, expenditures per person served can reflect the ability to pay by dividing by per capita personal income.

The choice of whether to use population or personal income to adjust the government finance data can make a large difference in the interpretation of the data. Per capita personal income differs substantially across geographic areas, and can vary significantly over time in a particular geographic area relative to the national average. For example, Arizona's per capita personal income in 2015 was 18 percent below the national average, but the differential in 1971 was only 3 percent.

Table I-1 illustrates the magnitude of the differences between using personal income or population to adjust government finance data in Arizona. In the top portion of the table, Arizona is compared to the national average on total state and local government revenues. Arizona is much further below the national average on a per capita basis, even after adjustment for the cost of living, than if adjusted for personal income.

In the bottom portion of Table I-1, the changes over time in the revenues and expenditures of the state government's general fund are compared. Over the period from FY 2007 to FY 2016, revenues and expenditures declined at comparable rates measured on a per capita basis or relative to personal income, because inflation-adjusted per capita personal income was unchanged. In contrast, over the period from FY 1992 to FY 2016, the decrease in revenues and expenditures was much larger based on the personal income adjustment than on the per capita measure, since inflation-adjusted per capita personal income rose substantially.

¹⁰ For a discussion of the importance of education and infrastructure, see Arizona State University, L. William Seidman Research Institute, *Overview of Economic Competitiveness: Business and Individual Location Factors, With a Focus on Arizona*, November 2014, <https://wpcarey.asu.edu/sites/default/files/uploads/center-competitiveness-and-prosperity-research/competitiveness11-14.pdf>.

TABLE I-1
ILLUSTRATIONS OF ADJUSTMENTS IN ORDER TO COMPARE GOVERNMENT FINANCE DATA
OVER TIME AND ACROSS GEOGRAPHIES

ARIZONA STATE AND LOCAL GOVERNMENT REVENUE

	Arizona	United States	Difference
Fiscal Year 2013			
Per Capita	\$6,728.99	\$8,541.00	-21.2 %
Per Capita, Adjusted for Cost of Living	6,944.26	8,541.00	-18.7
Per \$1,000 of Personal Income	182.57	191.91	-4.9

ARIZONA STATE GOVERNMENT GENERAL FUND

	Ongoing Revenues*	Ongoing Expenditures
Fiscal Year (FY) 2016		
Dollars in Thousands	\$9,232,816	\$9,419,593
Per Capita	1,356.12	1,383.56
Per \$1,000 of Personal Income	33.80	34.49
Percent Change, FY 2007 to FY 2016		
Dollars, Inflation Adjusted	-16.5%	-15.6%
Per Capita, Inflation Adjusted	-24.0	-23.2
Per \$1,000 of Personal Income	-23.9	-23.1
Percent Change, FY 1992 to FY 2016		
Dollars, Inflation Adjusted	67.3	66.8
Per Capita, Inflation Adjusted	-5.3	-5.6
Per \$1,000 of Personal Income	-33.6	-33.7

* After subtracting urban revenue sharing.

Sources: U.S. Department of Commerce, Census Bureau (state and local government revenue and population); Arizona Joint Legislative Budget Committee (general fund revenues and expenditures); and U.S. Department of Commerce, Bureau of Economic Analysis (personal income, regional price parities, and gross domestic product implicit price deflator).

II. STATE GOVERNMENT GENERAL FUND REVENUE

- General fund revenue fluctuates significantly with the economic cycle.
- General fund revenue has fallen by one-third since the early 1990s after adjusting for the state's growth.
- The decline in revenue largely results from a series of tax law changes that have reduced tax rates and added tax credits and tax exemptions. General fund revenue in fiscal year 2016 was \$4 billion less than it would have been had no tax law changes been made.
- The primary rationale provided for the tax law changes has been that tax reductions would boost economic growth.
- While supply-side economics and the Laffer Curve are valid concepts, they work only under certain conditions — and these conditions were not present in Arizona during the 1990s and 2000s when most of the tax reductions were implemented. There has been no discernible improvement in economic growth and therefore no boost in tax collections to offset the initial loss of revenue resulting from the tax reductions.
- The general fund's revenue system compares poorly to a set of guiding principles. The tax law changes generally have reduced the evaluation of the system.
- The tax law changes have made the general fund more dependent on the sales tax. Collections from the sales tax as currently structured are highly cyclical and do not keep pace with economic growth.
- The other major source of revenue for the general fund is the income tax. Collections from this tax also are highly cyclical.

This chapter discusses ongoing general fund revenue, excluding one-time adjustments. The data, which are available for fiscal years 1971 through 2016, come from the JLBC. The revenue figures for FY 2016 are preliminary; the figures for some of the detailed categories are not yet available.¹¹

Total Revenue

Total ongoing general fund revenue, expressed per \$1,000 of personal income, has fluctuated over time, as seen in Chart II-1. These fluctuations are the result of two factors:

- The economic cycle.
- Statutory changes in the tax code, such as reductions in tax rates, and changes in nontax sources of revenue.

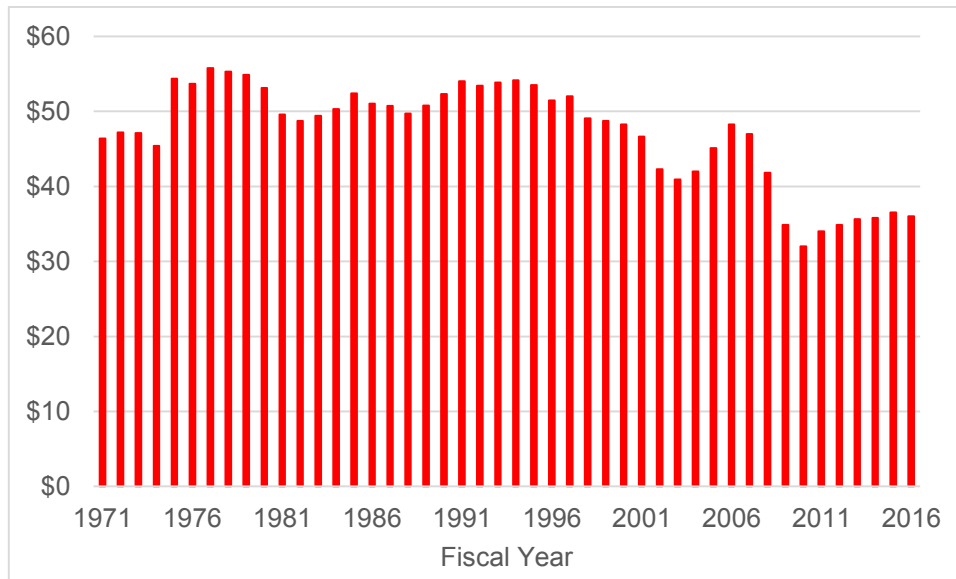
When ongoing revenue relative to personal income is falling, as in the late 1990s, government revenue — and therefore the capacity to deliver public services — is not growing as fast as the economy.

The period since the early 1990s displays both cyclicity and a downward trend in total ongoing general fund revenue relative to personal income. In order to distinguish between the cyclical and trend components, Chart II-2 adds a trend line to the graph of ongoing revenue relative to personal income since FY 1992. The downward trend largely results from a series of changes to tax laws, discussed below, that have reduced revenue.¹² The economic cycle contributed to the relatively low figures from FYs 2002 through 2004, the higher figures from FYs 2005 through 2007, and the lower figures from FYs 2009 through 2012. An improving economy pushed ongoing revenue relative to personal income slightly above the trend line starting in FY 2014.

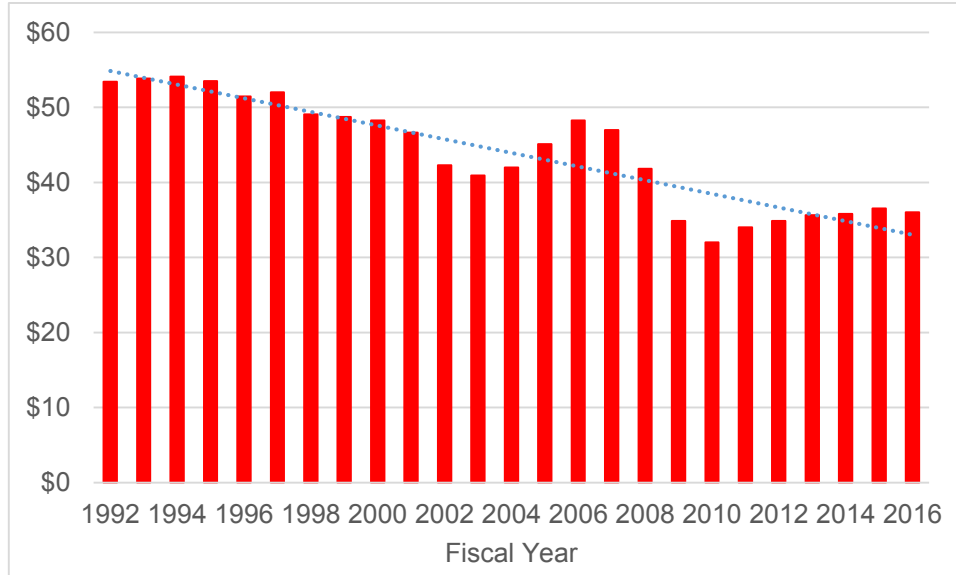
¹¹ The revenue figures are not finalized until December.

¹² The slope of the trend line in coming years will be affected by future policy decisions regarding taxes.

**CHART II-1
ONGOING REVENUE PER \$1,000 OF PERSONAL INCOME,
ARIZONA STATE GOVERNMENT GENERAL FUND**



**CHART II-2
ONGOING REVENUE PER \$1,000 OF PERSONAL INCOME WITH TRENDLINE,
ARIZONA STATE GOVERNMENT GENERAL FUND**



Note (Charts II-1 and II-2): Revenue is expressed before subtracting urban revenue sharing.

Sources (Charts II-1 and II-2): Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Relative to the FY 1992 figure, ongoing revenue relative to personal income was as much as 40 percent lower in FY 2010; the difference in FY 2016 was 33 percent. Another way to quantify the magnitude of the downward trend is to compare recent ongoing revenue relative to personal income to a long-term average. The FY 2016 figure was 30 percent lower than the average of the FY 1971-to-1992 period.

Tax Law Changes

The downward trend in ongoing revenue relative to personal income since FY 1992 is the result of numerous tax law changes. The most significant changes were reductions to tax rates, but the addition of tax credits and tax exemptions also contributed to a loss of revenue.¹³ Further, the changes resulted in the general fund becoming more dependent on the sales tax. Collections from the sales tax as currently structured do not keep pace with economic growth (as measured by personal income or gross product).

Since FY 1989, the JLBC has estimated the effect of every tax law change.¹⁴ The reductions were particularly large during the 1990s, especially after adjusting for inflation, population growth, and real per capita economic growth. Frequently, tax changes have been phased in over a period of years; the JLBC estimates also phase in the effects. The estimated effects by year are shown in Chart II-3. Additional tax reductions are scheduled to be implemented in each year through FY 2019.

During the 1990s, tax rates were reduced for the individual income tax, property tax, and vehicle license tax. A number of sales tax exemptions were passed and new income tax credits were allowed. The individual income tax was disproportionately affected, with hardly any reduction in the corporate income tax.

In the 2000s, most of the tax changes affected the income taxes. While reductions in tax liability were made to the corporate income tax, the largest reductions in FYs 2007 and 2008 primarily applied to the individual income tax. Since FY 2010, the tax reductions again have been focused on the income taxes, but with the mix shifting to significant reductions in the corporate income tax.

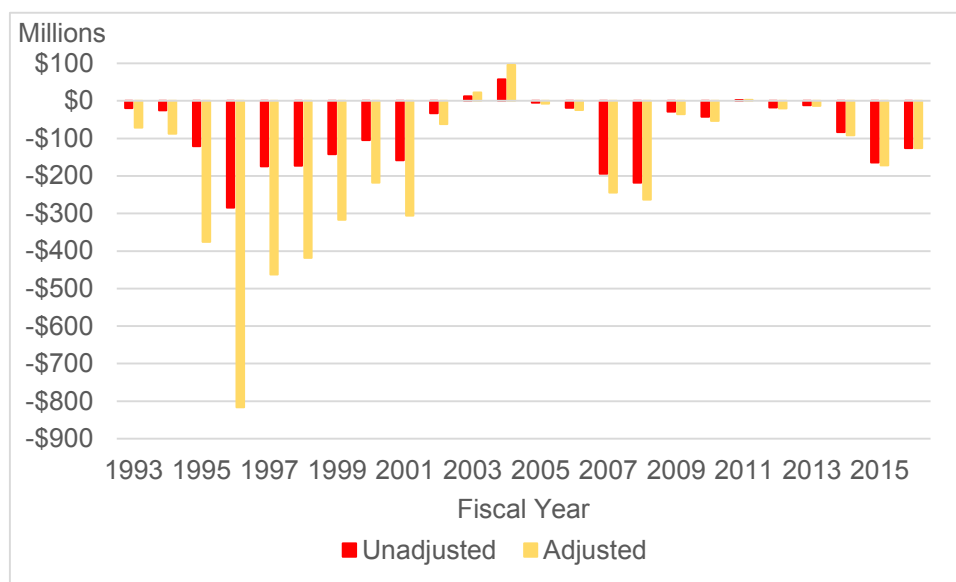
Taking all of the tax changes since FY 1992 into account and adjusting the nominal figures to reflect conditions in FY 2016, general fund revenue was approximately \$4.07 billion less in FY 2016 than it would have been had no tax changes been implemented. Even if no further tax reductions are passed in the next few legislative sessions, the total revenue loss from the tax cuts already passed will continue to increase as the phase-in of tax reductions continues.

Of the more than \$4 billion in lost general fund revenue in FY 2016 resulting from tax changes passed since the early 1990s, more than half (\$2.1 billion) came from the individual income tax, through rate reductions, new tax credits, etc. More than \$600 million was cut from the corporate income tax, while revenue reductions totaled more than \$500 million from the sales tax and close to \$500 million from the property tax. Changes to other taxes reduced general fund revenue by nearly \$300 million.

¹³ The Arizona Department of Revenue details the many tax credits, tax exemptions, and other “tax expenditures” in its annual report *The Revenue Impact of Arizona’s Tax Expenditures*, <https://www.azdor.gov/ReportsResearch/TaxExpenditures.aspx>. According to the Department of Revenue, “Tax expenditures are provisions within the law designed to encourage certain kinds of activity or to aid taxpayers in certain categories. These provisions are generally known as exemptions, exclusions, deductions, subtractions and credits. Such provisions result in a loss of tax revenues, thereby reducing the amount of revenues available for state (and, in some circumstances, local) programs. In effect, the fiscal impact of implementing a tax expenditure would be similar to a direct expenditure of state funds.”

¹⁴ See Arizona Joint Legislative Budget Committee, *2015 Tax Handbook*, September 2015, Appendix D, <http://www.azleg.gov/jlbc/15taxbook/15taxbk.pdf>.

CHART II-3 ESTIMATE OF ANNUAL CHANGE IN ONGOING TAX REVENUE DUE TO STATUTORY CHANGES, ARIZONA STATE GOVERNMENT GENERAL FUND



Notes:

- Revenue from the temporary sales tax increase in FYs 2011 through 2013 is not included.
- The adjusted figures reflect inflation, population growth, and real per capita economic growth.

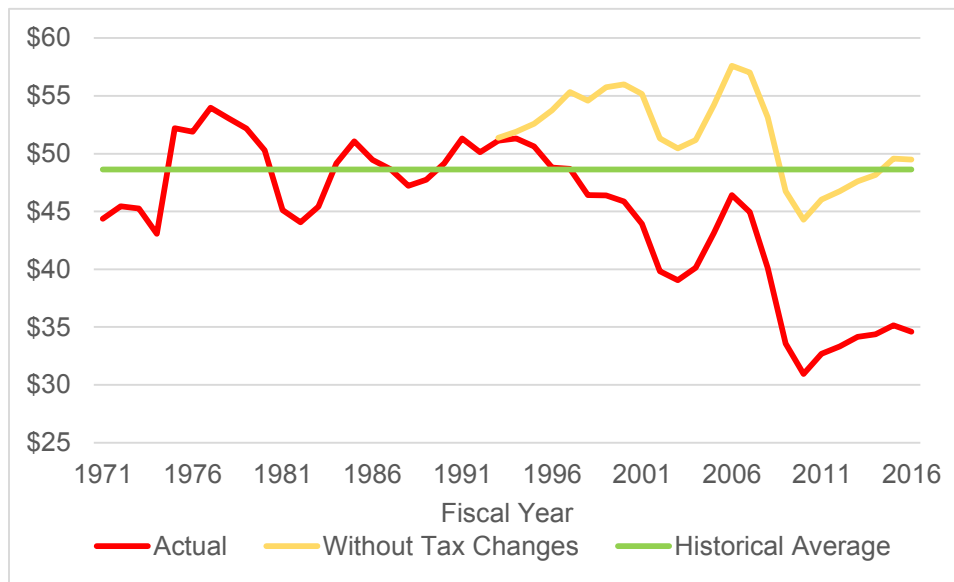
Sources: Arizona Joint Legislative Budget Committee, *2015 Tax Handbook*, September 2015, Appendix D, <http://www.azleg.gov/jlbc/15taxbook/15taxbk.pdf> (unadjusted estimates). The adjusted figures were calculated using personal income, as reported by the U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm>.

In FY 2015, the general fund’s a loss of revenue from the tax law changes was \$3.75 billion. In contrast, voter-approved tax increases boosted revenue to other funds by about \$900 million in FY 2015. Thus, the net loss to state government from tax changes was \$2.85 billion in FY 2015. Other funds benefited from four increases in the tobacco tax passed by voters between 1994 and 2006, totaling close to \$300 million in FY 2015. The additional revenue from these tobacco tax increases primarily is directed to health programs and to early childhood development. In addition, a 0.6 increase in the sales tax rate was passed by voters in 2000 to benefit education, which raised a little more than \$600 million in FY 2015.¹⁵

Had no tax changes affected the general fund since the early 1990s, tax revenue per \$1,000 of personal income in FY 2016 would have been slightly higher than the historical norm (see Chart II-4). The below-average revenue figures after adjusting for tax reductions from FYs 2009 through 2014 were due to the severity of the last recession and the slow economic recovery that followed.

¹⁵ Voters approved Proposition 301 in November 2000, raising the general sales tax rate from 5.0 percent to 5.6 percent from July 2001 through June 2021. Most of this revenue goes to elementary and secondary education, with lesser amounts directed to the School Facilities Board and higher education.

CHART II-4
ONGOING TAX REVENUE PER \$1,000 OF PERSONAL INCOME,
ARIZONA STATE GOVERNMENT GENERAL FUND



Notes:

- Ongoing tax revenue is expressed prior to the subtraction for urban revenue sharing.
- The general fund tax revenue without tax changes is based on estimates of what general fund tax revenue would have been had no changes to tax laws been made since FY 1992.
- The historical average is based on fiscal years 1971 through 1992.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc.htm> (actual general fund revenue and estimated impact of tax changes), and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Supply-Side Economics¹⁶

Supply-side economics is based on the concept that tax reductions stimulate economic growth, with the stimulus so great that government revenue rises despite the lower tax rates. The economist Arthur Laffer brought this relationship into the popular literature in the 1970s. Initially, his focus was national tax rates, particularly the federal income tax, which was quite high in the 1970s, but the “Laffer Curve” conceptually applies to state and local tax rates as well. In reality, the Laffer Curve is a mathematical relationship (Rolle’s Theorem), the analytical foundations of which were established centuries ago.

The concept is simple. A single tax rate produces the greatest government revenue. Setting rates below this optimal point leaves governments with less than maximum revenue but setting rates higher than the optimal point has a negative impact on economic activity, which results in lower tax collections despite the higher tax rate. The relationship between tax rates and revenue collected follows a curve. The exact shape of the curve can vary by specific circumstances, but the end points always are the same: No tax results in no public revenue while a 100 percent tax rate would cause all legal economic activity to cease.

While the general concept of supply-side economics and the Laffer Curve is simple and based on a mathematical relationship, it has a number of limitations:

- In real-world application, it is difficult to identify the tax rate that constitutes the optimal point and to describe the exact shape of the Laffer Curve.
- The relationship may not hold when considering the effective rate of one type of tax. For example, if a region’s overall tax burden is higher than optimal, lowering the effective tax rate on one type of tax from higher than to optimal may not generate much of an economic effect if the overall tax burden remains higher than optimal.
- The relationship between taxes and economic growth/government revenues is much stronger for business taxes than for individual taxes.
- Since state and local government tax payments are small relative to federal tax payments and to other expenses, a decrease in a state or local tax rate that is higher than optimal will have a relatively small supply-side effect. For example, Arizona’s maximum personal income tax rate is 4.54 percent. Nationally, the top rate is 39.6 percent. The federal rate was as high as 90 percent in the 1960s.
- If a regional economy is at full capacity (unemployment rate is low, business and industrial building vacancy rates are low), then a boost to the economy from a reduction in taxes will not have a net positive effect on government finances. To accommodate the increase in economic growth, more people will have to move to the region to fill the new jobs created. Thus, while government revenues may increase, public expenditures will increase as well in order to serve the new residents and businesses.

The Laffer Curve demonstrates that when an effective tax rate is higher than optimal, a tax reduction can result in increased government revenue. If an effective tax rate is optimal or less than optimal, however, a tax reduction will result in a decrease in government revenue. This distinction has been lost in many discussions of taxation. Some proponents of limited government erroneously argue that tax rates are always higher than optimal and that reduced taxation always is beneficial.

¹⁶ For more information on supply-side economics and its application in Arizona, see Grand Canyon Institute, *The Effects of Tax Reductions in Arizona: Significantly Reduced Government Revenue and No Apparent Impact on Economic Growth*, February 2013 http://grandcanyoninstitute.org/sites/grandcanyoninstitute.org/files/GCI_Policy_Tax_Reductions_Feb_2013.pdf. Also see Chapter 4 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

The tax cuts made to Arizona's general fund during the 1990s and 2000s were not followed by any discernible increase in economic growth or in government revenue. An empirical review indicates that per person economic growth (measures of prosperity) and per employee gains (proxy measures of productivity) have been no higher since the tax reductions were implemented than in earlier years. Aggregate economic growth actually is lower since the tax cuts went into effect, though this is not necessarily a result of the tax reductions — many factors affect economic growth and taxes are not of particular importance. With no increase in economic growth, state government revenues have dropped by amounts similar to those estimated by the JLBC as resulting from the tax cuts.

There are a number of likely reasons why the tax cuts during the 1990s and 2000s did not have a beneficial effect in Arizona:

- The overall state and local government tax burden in Arizona was not above the national average even when the first tax cuts took effect.
- The tax reductions disproportionately targeted taxes paid by individuals.
- State and local government taxes are not one of the most important location factors for businesses. The labor force and physical infrastructure are more important, but Arizona does not compare favorably on these measures.¹⁷
- Arizona did not have underutilized resources when the tax cuts of the 1990s and 2000s were implemented.

Since the tax reductions passed since FY 2010 more heavily affect business taxes, it is possible that some positive effect on economic growth may be realized. However, the magnitude of any economic boost and subsequent government revenue increase likely will be small, with any gain in revenue offsetting only a fraction of the revenue lost due to the tax cuts.

Revenue by Source

Ongoing general fund revenue by source in FY 2015 is displayed in Table II-1. Ninety percent of the revenue came from just two sources: the sales tax and the income tax.

Relative to personal income, ongoing general fund revenue has dropped substantially, by 33 percent between FYs 1992 and 2016, including a 23 percent drop between FYs 2007 and 2016. When the percent change in revenue relative to personal income is negative, revenue collections are not keeping pace with economic growth. Thus, the public sector is not able to deliver public services at a pace to match the growth in demand.

Substantial declines have occurred in almost all of the revenue sources. However, the magnitudes of the decreases vary by revenue source, substantially shifting the mix of sources over time. To get a more complete picture of the changing revenue mix, the shares in FY 1971 are compared to those in FY 2016 in Table II-2. Large changes in share occurred among the tax sources of revenue. In FY 1971, the general fund received significant amounts of revenue from a number of taxes. In FY 2016, the sales tax and the income tax accounted for 94 percent of the general fund's tax revenue, up from 68 percent in FY 1971. Despite the significant changes in the tax sources, the share of total ongoing revenue provided by taxes did not change much. Similarly, changes occurred in the mix of

¹⁷ For a discussion of business location factors, see Arizona State University, L. William Seidman Research Institute, *Overview of Economic Competitiveness: Business and Individual Location Factors, With a Focus on Arizona*, November 2014, <https://wpcarey.asu.edu/sites/default/files/uploads/center-competitiveness-and-prosperity-research/competitiveness11-14.pdf>.

nontax revenue. In FY 1971, neither the State Lottery nor the disproportionate share program¹⁸ had been created, but the subsequent increases in their shares of total revenue were not substantial.

The mix of revenue sources used by the general fund does not compare favorably against a set of revenue system guiding principles. These guiding principles are summarized in the box on page 19.¹⁹ In addition to the guiding principles specific to the revenue system, an additional guiding principle applies to the entire fiscal system. Sometimes labeled as “accountability,” this principle states that revenues and expenditures should be linked. In particular, a decrease in revenue, as from a tax reduction, should be matched by a reduction in expenditures and an increase in expenditures should be matched by an increase in revenues.

¹⁸ According to the JLBC, the disproportionate share program provides supplemental payments of federal and state dollars to hospitals that serve a large, or disproportionate, number of low-income patients. Some of the revenue received from the federal government through this program is placed in the general fund and is used to pay for the increasing costs of AHCCCS (Arizona Health Care Cost Containment System, the state’s alternative to Medicaid).

¹⁹ For a discussion of the guiding principles, see Chapter 11 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

TABLE II-1
ONGOING REVENUE BY SOURCE,
ARIZONA STATE GOVERNMENT GENERAL FUND

	Fiscal Year 2016 (Preliminary)		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1992 to 2016	FYs 2007 to 2016
ONGOING TOTAL*	\$9,838,450	100.00 %	-33 %	-23 %
Taxes	9,448,317	96.03	-31	-23
Sales and Use	4,315,187	43.86	-28	-24
Income	4,538,468	46.13	-21	-24
Individual	3,967,920	40.33	-19	-16
Corporate	570,548	5.80	-32	-54
Property	38,541	0.39	-95	25
Luxury	57,869	0.59	-80	-30
Insurance Premium	490,576	4.99	22	-3
Other	7,677	0.08	-99	683
Nontax Revenue	390,133	3.97	-57	-29
Lottery	76,973	0.78	-45	15
Licenses, Fees, Permits	161,242	1.64	-51	-14
Interest Earned	13,338	0.14	-79	-90
Transfers and Reimbursements	44,714	0.45	-79	82
Disproportionate Share	93,866	0.95	-43	-34
Urban Revenue Sharing	-605,634			
ONGOING TOTAL**	9,232,816		-34	-24

* Before subtracting urban revenue sharing.

** After subtracting urban revenue sharing.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

TABLE II-2
ONGOING REVENUE BY SOURCE, SHARE OF TOTAL,
ARIZONA STATE GOVERNMENT GENERAL FUND

	Fiscal Year 1971	Fiscal Year 2016	Change
Taxes	95.59 %	96.03 %	0.44
Sales and Use	36.69	43.86	7.19
Income	28.32	46.13	17.81
Individual	20.85	40.33	19.48
Corporate	7.47	5.80	-1.67
Property	13.71	0.39	-13.32
Luxury	8.40	0.59	-7.81
Insurance Premium	2.63	4.99	2.36
Other	5.84	0.08	-5.76
Nontax Revenue	4.41	3.97	-0.44
Lottery	-	0.78	0.78
Licenses, Fees, Permits	1.03	1.64	0.61
Interest Earned	1.91	0.14	-1.77
Transfers and Reimbursements	1.47	0.45	-1.02
Disproportionate Share	-	0.95	0.95

Note: Shares calculated before subtracting urban revenue sharing.

Source: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm>

REVENUE SYSTEM GUIDING PRINCIPLES

1. **Stability:** The revenue system should minimize year-to-year fluctuations in revenues over the economic cycle. Multiple revenue sources should be used and an adequately funded rainy-day fund should be in place to offset the inevitable cyclical fluctuations in revenue.
2. **Responsiveness:** The revenue system should produce revenues that keep pace with long-term growth in the state's economy.
3. **Predictability:** A stable and responsive revenue system produces a predictable stream of revenues, benefitting taxpayers and policymakers. Frequent changes to the revenue system negatively affects predictability as well as other guiding principles.
4. **Efficiency:** Revenue policies should have minimal impacts on economic behavior. Revenue sources should be broad based with low marginal tax rates.
5. **Competitiveness:** Revenue policies should promote economic vitality and prosperity. The division of the revenue burden between businesses and individuals should be equitable.
6. **Exportability:** The revenue system should be designed to tax nonresidents (such as tourists and seasonal residents) as well as residents.
7. **Neutrality:** Different treatment of similar economic activities should be minimized. The use of tax credits and exemptions should be limited.
8. **Horizontal Equity:** Revenue policies should treat people of equal means similarly. This principle should be applied for each revenue source.
9. **Vertical Equity:** The overall tax structure should minimize regressivity. Overall tax payments as a proportion of income should not be higher for those with lower incomes than for other taxpayers.
10. **Simplicity:** The revenue system should be designed to minimize costs of compliance and administration.

In Table II-3, the revenue system specific to the state general fund is appraised; the evaluations for the entire revenue system used by state government are different.²⁰ In general, the ideal revenue base is broad, with low tax rates applied. Instead, the general fund has a narrow base with a high sales tax rate. A discussion of each of the general fund revenue sources follows.^{21 22 23}

²⁰ In particular, the evaluation of competitiveness for the entire revenue system would be lower due to high business property taxes, which do not benefit the general fund.

²¹ For a general discussion of revenue sources, see Chapter 3 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

²² For an analysis of Arizona's general fund revenue, see University of Arizona, Economic and Business Research Center, *Arizona General Fund Tax Revenues: An Historical Perspective*, November 2013, <https://www.azeconomy.org/2013/11/economy/arizona-general-fund-tax-revenues-historical-perspective/>

²³ For a detailed explanation of each tax revenue source, see the Arizona Joint Legislative Budget Committee, annual *Tax Handbook*, <http://www.azleg.gov/jlbc/economicanalysis.htm>

**TABLE II-3
A QUALITATIVE ASSESSMENT OF THE REVENUE SYSTEM,
ARIZONA STATE GOVERNMENT GENERAL FUND**

Guiding Principle	Evaluation*	Comments
Stability and Predictability	Very Poor	Highly cyclical revenues, multiple changes to tax laws, poor use of rainy-day fund, overemphasis on sales tax, little use of more stable revenue sources
Responsiveness	Poor	Overemphasis on the sales tax, whose narrow base causes collections to lag behind economic growth
Efficiency	Poor	Heavy reliance on two taxes; the sales tax has a high tax rate
Competitiveness	Good	Recent corporate income tax reductions have improved this evaluation
Exportability	Good	Some of the tax burden is borne by nonresidents
Neutrality	Very Poor	Multiple tax credits and exemptions
Horizontal Equity	Poor	Due to tax credits and exemptions, similar individuals and businesses may have differing tax burdens
Vertical Equity	Poor	The declining use of the progressive income tax shifts the tax burden to the regressive sales tax — those with low incomes pay a higher share than those with high incomes
Simplicity	Poor	Complex tax laws

* Relative to a system of best practices.

Source: The assessment is made by the author.

Sales and Use Tax

More accurately, this tax is referred to as the transaction privilege tax (TPT) because the tax is imposed upon the seller rather than the buyer of the taxable item. It consists of 16 classifications, of which the tax on retail items is the largest.²⁴ The TPT is imposed on the total gross receipts of taxable businesses, with the exception of prime contractors, who are taxed at 65 percent of their gross receipts. In 14 of the 16 classifications, the current state tax rate is 5.6 percent. The current tax rate consists of a permanent rate of 5.0 percent plus a rate of 0.6 percent directed to education that is in effect through June 2021.

In addition to the state tax rate, counties and incorporated cities and towns also can levy a TPT tax. The total state and local government TPT tax rate varies by jurisdiction from 7.6 percent to 10.9 percent.

The general fund does not receive all of the TPT revenue from the state tax. The 0.6 portion is dedicated to education and does not enter the general fund. More than 22 percent of the TPT collections from the 5.0 percent rate in FY 2015 were shared with counties and incorporated cities and towns.

As currently structured, the TPT in Arizona compares poorly to the guiding principles in several ways. It has a narrow base, a high tax rate, and a number of exemptions. The tax generally is applied only to goods, with medicine, medical supplies, and food purchased at grocery stores for home consumption exempted. Most services and many Internet purchases are not taxed. In part due to the narrow base, tax collections are cyclical. The narrow base also causes collections from the TPT to grow less rapidly than the economy, as consumer purchases continue to shift from taxable goods to nontaxed goods and services.²⁵

Chart II-5 illustrates the decline in sales and use tax revenue relative to personal income that has occurred since the mid-1980s, despite no lowering of the tax rate.²⁶ The decline over time reflects not only the shift of consumer spending to goods and services that are not taxed but also changes in the tax code, which have added numerous tax exemptions. A number of statutory changes, mostly passed in the mid-to-late 1990s, had significant effects on TPT revenue. The largest of these were the phase-out of the commercial lease tax (it remains a category of the TPT but has a tax rate of zero) and changes to the prime contracting sales tax. The statutory changes to the TPT since the early 1990s reduced general fund sales and use tax revenue in FY 2016 by more than \$500 million.

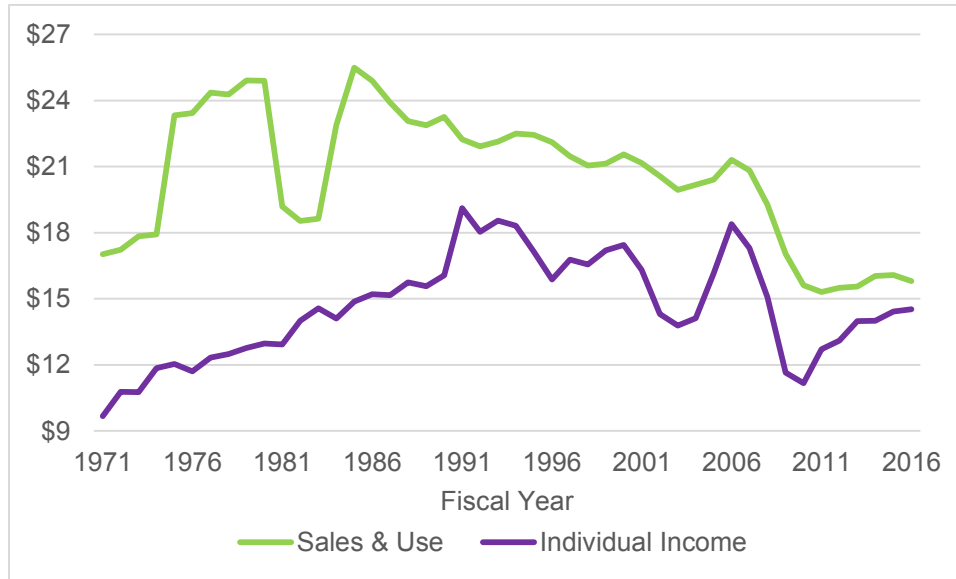
There are other ways in which the TPT in Arizona compares poorly to the guiding principles. The sales and use tax is highly regressive — taxes paid by low-income Arizonans makes up a higher share of their income than the taxes paid by those with higher incomes. For those remitting the tax (sellers), the TPT is complex — each taxing jurisdiction in the state has its own tax rate and tax base. The high tax rate also negatively affects businesses. The box on page 23 provides more information on the sales tax.

²⁴ The 16 separate classifications are retail, transporting, utilities, telecommunications, publication, job printing, pipeline, private car line, commercial lease, transient lodging, personal property rental, mining, amusement, restaurant, prime contracting, and owner builder sales.

²⁵ For more detail, see University of Arizona, Economic and Business Research Center, *Arizona's Eroding Sales Tax Base*, June 2014, <https://www.azeconomy.org/2014/06/featured/az-eroding-sales-tax-base/>.

²⁶ The sharp decline in sales and use tax revenue in FY 1981 and the rebound in FY 1984 reflects first the exemption of food for home consumption and then an increase in the tax rate to offset the revenue lost from implementing the exemption for food for home consumption.

**CHART II-5
ONGOING TAX REVENUE PER \$1,000 OF PERSONAL INCOME FROM MAJOR
SOURCES, ARIZONA STATE GOVERNMENT GENERAL FUND**



Note: Revenue from the temporary sales tax increase in FYs 2011 through 2013 is not included.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Perspectives on the Sales Tax
Alberta Charney, Senior Research Economist,
Economic and Business Research Center, University of Arizona

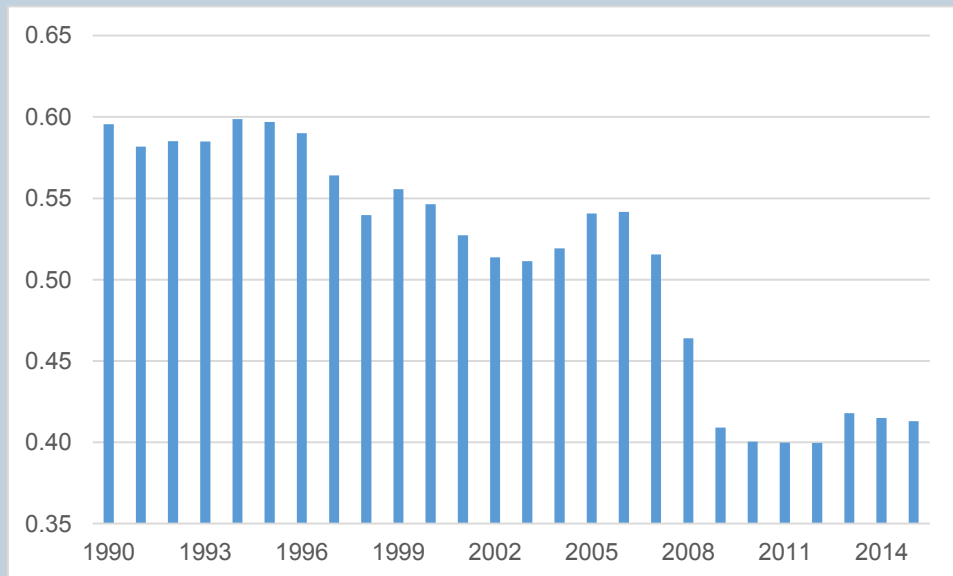
Sales taxes and selective sales taxes (such as taxes on tobacco and alcoholic beverages) are regressive taxes, which place a higher tax burden on lower-income families than high-income families. High-income households spend lower portions of their income on taxable items. Exemptions for food to be consumed at home, medicine, and medical equipment somewhat mitigate the regressivity.

The responsiveness of the sales tax base varies over time. During periods of economic growth, growth of sales tax revenue is less than the growth in income, but in downturns, sales tax growth falls substantially behind. From 1990 through 2006, the responsiveness was between 0.88 and 0.91, depending on the method used to calculate it. A 0.88 responsiveness means that for every 10 percent increase in income, the sales tax increased only 8.8 percent. During the great recession, from 2006 through 2009, the responsiveness fell to 0.76. Since then, the responsiveness has been between 1.0 and 1.2 (depending on method used), but the improved responsiveness is due to post-recession catch-up spending, particularly on durable goods (such as automobiles and large appliances), and is not expected to last. For the entire 1990-to-2015 period, the responsiveness of the sales tax base was between 0.73 and 0.76.

The sales tax base, relative to personal income, has eroded over time. In 1990, the sales tax base was 60 percent of personal income; by 2015, it was 41 percent, as seen in the following chart. Contributing causes of this decline are the national shift in purchases from goods toward services, increasing income inequality, consumer debt, and student debt.

Taxing only goods contributes to cyclicalities because purchases of some goods, specifically durable goods, are very cyclical. The food exemption also increases cyclicalities.

RATIO OF SALES TAX BASE TO PERSONAL INCOME



Individual Income Tax²⁷

Individual income tax is paid not only by individuals, but also by businesses organized as sole proprietorships and partnerships. In addition, small business corporations (S corps) can elect to pass their income to shareholders, who pay the individual income tax.

The calculation of the Arizona income tax begins with federal adjusted gross income, so the base is similar to that used nationally. After subtracting exemptions and deductions (standardized or itemized), the resulting state adjusted income is used to compute the Arizona tax liability. Relative to the federal tax form, Arizona permits deduction of most medical expenses, and allows the deduction of federal income taxes paid.

The individual income tax is a progressive tax. Marginal tax rates in the early 1990s had ranged from 3.8-to-7.0 percent, but after seven rate reductions, the current marginal tax rates range from 2.59 percent at low incomes to 4.54 percent at high incomes. Since the top rate decreased more than the bottom rate, the progressivity of the tax has lowered over time. The lowest tax rate has been applied to incomes of less than \$10,000, while the highest rate has been applied to incomes of \$150,000 or more. Beginning in 2015, the income brackets are adjusted annually for inflation, as measured by the Consumer Price Index for Metropolitan Phoenix.

The general fund does not receive all of the revenue from the personal income tax, as 15 percent is shared with incorporated cities and towns two years later through urban revenue sharing, which is discussed in Chapter VII.

The income tax in Arizona compares more favorably to the guiding principles than the sales tax due to its progressivity and its revenues growing with the economy. However, income tax collections are highly cyclical and numerous tax credits exist. Part of the cyclicity is due to a small number of very high-income taxpayers paying a significant share of the total tax; much of the income from this group is volatile and derives from investments.²⁸ More generally, the increase in volatility in general fund revenue over the last two decades has largely been due to the booms and busts of capital gains. The box on the next page provides more information on the individual income tax.

The strong cyclicity in individual income tax collections is seen in Chart II-5. Apart from the cyclicity, revenue has declined relative to personal income since the early 1990s, a result of numerous changes to the tax code, including reductions in tax rates and the introduction of various tax credits. The statutory changes to the individual income tax since the early 1990s reduced general fund revenue in FY 2016 by \$2.1 billion, mostly the result of a series of rate reductions. Over the past few years, collections have increased relative to personal income, the result of the economy swinging from recession to expansion. Forecasts suggest that income tax collections relative to personal income may rise a bit further, but then will drop as the economy falls into the next economic recession.

²⁷ For considerably more information on the income tax, see Arizona State University, L. William Seidman Research Institute, *Arizona's Income Taxes: A Comparison With Other States and a Policy Discussion of Potential Tax Reforms*, July 2016, <https://wpcarey.asu.edu/sites/default/files/incometax07-16.pdf>.

²⁸ According to the Arizona Department of Revenue, in tax year 2014, the 4,905 resident tax filers with income of at least \$1 million (0.2 percent of the total number) accounted for 16 percent of the total tax paid by residents. The 175 filers with income of at least \$10 million paid nearly 5 percent of the total.

Perspectives on the Individual Income Tax
Alberta Charney, Senior Research Economist,
Economic and Business Research Center, University of Arizona

Arizona's individual income tax structure is progressive, in that the rates are higher for taxpayers with higher incomes. Exemptions and deductions add to the progressivity of the income tax structure but the deductibility of federal income taxes slightly reduces the progressivity of the structure from what it would otherwise be. Progressive income tax structures can offset the regressivity of sales taxes and selective sales taxes.

The responsiveness of the income tax was examined both with and without the tax cuts passed since the early 1990s. From 1991 through 2013, the annual average responsiveness of actual income tax liabilities was 0.98, meaning if personal income increased by 10 percent, the income tax increased by 9.8 percent. This effect is cumulative, so that it resulted in the ratio of income tax liability to personal income falling from 1.76 in 1990 to 1.28 in 2013. In an alternative analysis, tax liabilities are adjusted upward over time, effectively reversing the tax rate cuts to reflect the underlying income tax base. The estimated responsiveness of the rate-adjusted tax base is 1.08, meaning that for every 10 percent increase in personal income, the income tax base increases by approximately 10.8 percent. If there had been no tax credits, which have grown over time, the responsiveness would have been 1.1.

Income tax collections are more cyclical than the overall economy. The capital gains portion of the income tax base contributes substantially to the cyclicity of the income tax.

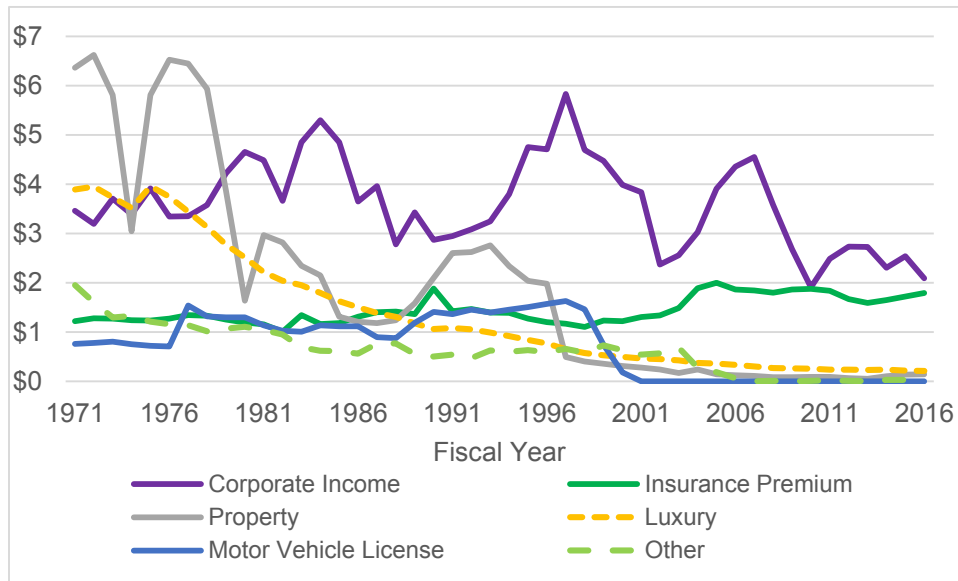
Corporate Income Tax

The corporate income tax applies one rate to all taxpayers. While numerous rate reductions in the individual income tax were passed during the 1990s and 2000s, decreases in the corporate income tax rate were limited until FY 2008. The rate was 5.5 percent in FY 2016, down from a rate of 9.3 percent in the early 1990s. In the current fiscal year (2017), the rate is 4.9 percent, at which it is scheduled to remain in subsequent years. The general fund does not receive all of the revenue from the corporate income tax, as 15 percent is shared with incorporated cities and towns two years later through urban revenue sharing.

As seen in Chart II-6, revenue from the corporate income tax has been highly erratic. While collections are correlated to the economic cycle, the cycle does not fully explain the erratic collections. Thus, revenue from this source is difficult to project.

Corporate income tax revenue has declined relative to personal income since the late 1990s, but particularly since FY 2007. Numerous changes to tax laws have been passed since then and will continue to be implemented through FY 2019, including reductions in tax rates, changes in the calculation of the tax due for multistate corporations, and the introduction of various tax credits. The statutory changes to the corporate income tax since the early 1990s reduced general fund revenue in FY 2016 by more than \$600 million. The impact will grow considerably in the next few years as the phase-in of already-passed changes continues.

CHART II-6
ONGOING TAX REVENUE PER \$1,000 OF PERSONAL INCOME FROM OTHER SOURCES,
ARIZONA STATE GOVERNMENT GENERAL FUND



Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Property Tax

For decades, the state levied a property tax, with revenue deposited in the general fund. The rate varied by year, since this tax was used in part to offset cyclical variations in revenue from other sources. Thus, the erratic pattern seen in Chart II-6 from the 1970s into the 1990s largely reflects these rate changes; property tax collections typically are not as cyclical as sales tax and income tax collections. General fund revenue from the property tax trended down from the 1970s through the 1990s. The state levy was eliminated in FY 1997, though the general fund continues to receive some property tax revenue (\$38.5 million in FY 2016, less than 0.4 percent of general fund revenue) from properties that are not located within any school district or from property in certain school districts that are ineligible for state aid. The statutory changes to the property tax since the early 1990s reduced general fund revenue in FY 2016 by close to \$500 million.

The property tax compares more favorably to the guiding principles than the sales tax due to the relative stability of property tax collections over the economic cycle; in addition, its revenues grow with the economy. However, high business property taxes are a negative factor for economic competitiveness. Since this tax is a primary source of revenue for local governments, it is discussed further in Chapter VII.

Luxury Taxes

The state's "luxury" taxes apply to purchases of alcoholic beverages and tobacco products. Less than half of the revenue collected from the alcoholic beverages tax, and less than 10 percent collected from the tobacco tax, is deposited in the general fund.

Significant increases in tobacco tax rates were passed by voters between 1994 and 2006, but these additional revenues did not flow to the general fund. As seen in Chart II-6, a significant decline relative to personal income in general fund revenue from the luxury taxes has occurred since the mid-1970s. In addition to changes in the distribution of luxury tax revenue away from the general fund, two other factors contribute to the decline in general fund revenue: the consumption of tobacco products continues to fall, and luxury tax revenue does not keep up with inflation because the taxes are imposed on a per unit basis rather than as a percentage of price. For example, the tax on cigarettes is \$2 per pack and the tax on wine is 84 cents per gallon.

Insurance Premium Tax

The insurance premium tax is imposed on net insurance premiums received by insurance companies for risks that exist within the state. Revenue from this source is relatively stable. While some of the revenue is used for other purposes, 93 percent of the total went to the general fund in FY 2015.

Unlike the other general fund tax sources, revenue from this source has not lowered over time, as hardly any changes have been made to the tax code that affected revenue collection. In fact, the only significant change was the removal of an exemption, which raised revenue in FY 2005 (see Chart II-6). However, in 2015, some tax law changes were made that will slightly reduce future revenue from this source.

Other Taxes

In the past, the general fund received revenue from the motor vehicle license tax, the pari-mutuel tax, and the estate tax, but the general fund no longer receives any revenue from these sources. Combined revenue from these taxes were relatively stable over time. Revenue from the motor vehicle license tax was significant, but the general fund portion was phased out between FYs 1999 and 2001. Revenue from the estate tax was moderate, but this tax was phased out after FY 2003. The statutory changes to these other taxes since the early 1990s reduced general fund revenue in FY 2016 by approximately \$300 million.

The JLBC identifies five categories of nontax revenue applied to the general fund: state lottery (which began in 1982); licenses, fees and permits; interest earned; transfers and reimbursements; and disproportionate share revenue (which began in 1992). These sources combined accounted for about 4 percent of total revenue in FY 2016. Taken together, revenue from these sources has gone up and down over time relative to personal income, but display an overall downward trend.

III. USES OF STATE GOVERNMENT GENERAL FUND REVENUE

- Historically, general fund appropriations relative to the size of the state went up and down with the economic cycle. However, appropriations have continued to fall in recent years despite economic growth.
- General fund appropriations have trended down since the early 1990s after adjusting for the state's growth. The decrease over the last 25 years was 37 percent.
- Nearly three-fourths of the appropriations in the current fiscal year go to only three of the more than 100 state agencies: Department of Education, Arizona Health Care Cost Containment System, and Department of Corrections.
- Disproportionately large decreases in appropriations have been made to higher education and to an aggregate of relatively small state agencies.

This chapter discusses the uses of general fund revenue, otherwise referred to as appropriations or expenditures. The data come from the JLBC and are available for FYs 1979 through 2017.

General Fund Appropriations

Historically, general fund appropriations relative to personal income were pro-cyclical, as seen in Chart III-1, dropping in years of economic weakness, such as in fiscal years 2002 and 2003, and rising in years of economic expansion, such as from FYs 2004 through 2007. In line with this pattern, appropriations relative to personal income fell sharply in FYs 2009 and 2010 in response to the recession that lasted from calendar years 2008 into 2010. However, despite economic growth since FY 2010, appropriations per \$1,000 of personal income have continued to fall — inconsistent with the historical relationship.

Apart from this cyclicity, general fund appropriations relative to personal income have fallen — trended down — since the early 1990s. From fiscal years 1979 through 2002, appropriations per \$1,000 of personal income averaged \$48.28. The FY 2017 figure was only \$32.86 — 32 percent lower. The decrease between FYs 1992 and 2017 was 37 percent.

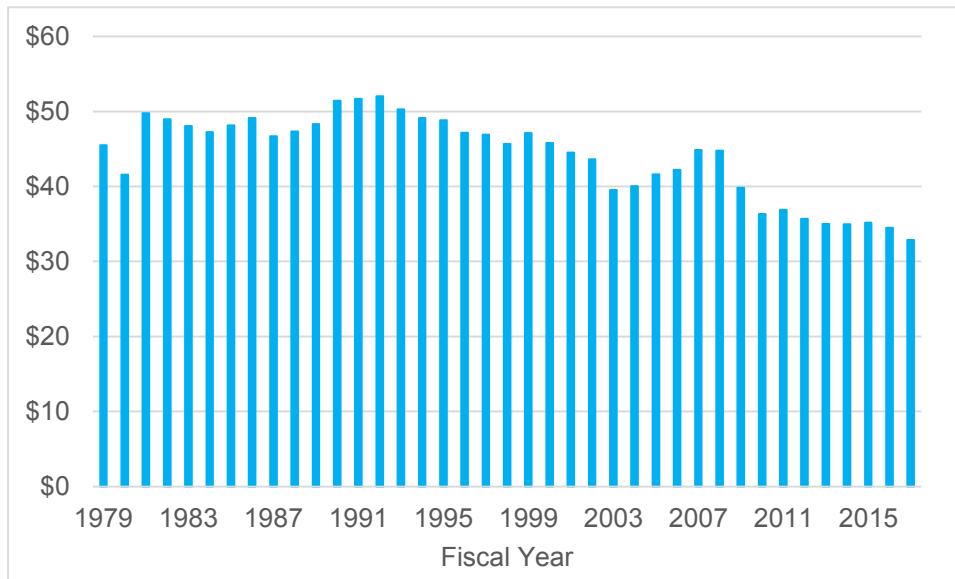
General Fund Appropriations by Major Agency

In FY 2017, the Department of Education, which provides operational funding to public elementary and secondary (K-12) school districts, received 43 percent of the general fund appropriations.²⁹ The Arizona Health Care Cost Containment System (AHCCCS, Arizona's form of Medicaid) received nearly 19 percent of the total and corrections received 11 percent of the total, as seen in Table III-1. Thus, only three of the more than 100 state agencies received 73 percent of the total appropriations from the general fund.

Most state programs have experienced sharp reductions in general fund appropriations relative to personal income. The overall decline was 37 percent between FYs 1992 and 2017, including a drop of 27 percent between FYs 2007 and 2017. Disproportionately large decreases occurred for higher education and for the aggregate of smaller agencies. In contrast, appropriations for the Department of Corrections hardly dropped.

²⁹ In contrast, the School Facilities Board administers funds that provide capital funding, such as for the construction of a new school, for K-12 school districts.

CHART III-1
ONGOING APPROPRIATIONS PER \$1,000 OF PERSONAL INCOME,
ARIZONA STATE GOVERNMENT GENERAL FUND



Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (appropriations) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Looking at a longer time period, the shares of general fund appropriations in FY 1979 are compared to those in FY 2017 in Table III-2. In FY 1979, AHCCCS had not yet been created. Similarly, the School Facilities Board (which administers funds that provide capital funding for K-12 school districts) was not yet in existence. The increases over time in the share of total spending for these programs, and for corrections, were offset by decreasing shares in most other programs, with higher education being particularly affected.³⁰ Table III-2 also compares appropriations per \$1,000 of personal income in FYs 1979 and 2017. A very large increase occurred for the combination of AHCCCS and the Department of Health Services and for the Department of Corrections, while very large decreases occurred for community colleges, universities, and the aggregate of smaller agencies.

The reductions in funding for public education do not seem to be consistent with the Arizona Constitution. Article XI, Section 10 states 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."³¹

³⁰ For more information, see University of Arizona, Economic and Business Research Center, *Arizona's General Fund Operating Expenditure Trends, 1979-2013*, November 2013, <https://www.azeconomy.org/2013/11/featured/arizona-general-fund-operating-expenditure-trends-1979-2013/>.

³¹ The text of the Arizona Constitution is available at <http://www.azleg.gov/Constitution.asp>.

**TABLE III-1
ONGOING APPROPRIATIONS BY AGENCY,
ARIZONA STATE GOVERNMENT GENERAL FUND**

	Fiscal Year 2017		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1992 to 2017	FYs 2007 to 2017
ONGOING TOTAL	\$9,429,885	100.00 %	-37 %	-27 %
Dept. of Education	4,069,376	43.15	-27	-24
AHCCCS*	1,750,941	18.57	x	x
Dept. of Corrections	1,046,683	11.10	-2	-4
Universities	698,472	7.41	-68	-45
Dept. of Economic Security**	530,124	5.62	x	x
Dept. of Child Safety**	379,179	4.02	x	x
School Facilities Board***	228,094	2.42	-	-58
Dept. of Public Safety	121,196	1.29	-37	-45
Judiciary	113,018	1.20	-63	-32
Dept. of Health Services*	86,552	0.92	x	x
Community Colleges	54,313	0.58	-85	-75
Legislature	51,380	0.54	-58	-34
Other	300,557	3.19	-72	-53
Agencies as Structured in FYs 1992 and 2007:				
AHCCCS	1,216,641	12.90	-31	-23
Dept. of Health Services	620,852	6.58	-25	-15
Dept. of Economic Security	909,303	9.64	-39	-7

* A significant program, Behavioral Health Services, was transferred from the Department of Health Services to AHCCCS effective at the beginning of FY 2017. This invalidates the percent changes for these agencies. At the bottom of the table, the budget for Behavioral Health Services was subtracted from AHCCCS and added to the Department of Health Services so that comparisons over time could be made.

** The Departments of Economic Security and Child Safety were combined until FY 2014, precluding the calculation of the percent changes for these agencies. The two agencies are combined on the last line of the table.

*** The School Facilities Board was created in the late 1990s.

Note: Changes in caseload are not considered in the calculation of the percent changes.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (appropriations) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

**TABLE III-2
ONGOING APPROPRIATIONS BY AGENCY,
ARIZONA STATE GOVERNMENT GENERAL FUND**

	Share of Total			Per \$1,000 of Personal Income		
	FY 1979	FY2017	Change	FY 1979	FY 2017	Change
TOTAL	100 %	100 %	-	\$45.50	\$32.86	-28 %
Dept. of Education	45.86	43.15	-2.71	20.87	14.18	-32
AHCCCS & Dept. of Health Services	4.84	19.48	14.64	2.20	6.40	191
Dept. of Corrections	4.28	11.10	6.82	1.95	3.65	87
Universities	19.06	7.41	-11.65	8.67	2.43	-72
Economic Security & Child Safety	10.86	9.64	-1.22	4.94	3.17	-36
School Facilities Board*	0.00	2.42	2.42	0.00	0.79	-
Dept. of Public Safety	1.53	1.29	-0.24	0.69	0.42	-39
Judiciary	0.56	1.20	0.64	0.25	0.39	56
Community Colleges	3.73	0.58	-3.15	1.70	0.19	-89
Legislature	1.01	0.54	-0.47	0.46	0.18	-61
Other	8.27	3.19	-5.08	3.77	1.06	-72

Source: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm>.

IV. BALANCE BETWEEN GENERAL FUND REVENUES AND EXPENDITURES

- Over the course of the economic cycle, the general fund swings from cyclical surpluses to cyclical deficits.
- The general fund has experienced a structural deficit over much of the last four decades. It was caused mostly by reducing revenues without reducing spending by an equal amount, though certain expenditures were increased without boosting revenues.
- Due to both a structural deficit and a cyclical deficit, the Legislature employed \$13.4 billion in “budget solutions” in fiscal years 2008 through 2012. One-fourth of the cumulative amount of \$13.4 billion represented permanent solutions, mostly coming from \$3.3 billion in spending reductions.
- The remainder came from one-time solutions, such as transfers to the general fund from other state funds, deferring payments, debt financing, and lease-purchase financing. The transfers have not been reversed and some of the payment deferrals remain.
- The Budget Stabilization Fund was intended to be a significant budget solution, but the original legislation was weakened, leaving its balance greatly inadequate to offset cyclical deficits. The BSF has not been fully funded during the current economic expansion.
- The majority of the general fund budget is controlled by funding formulas, in which funding is automatically increased for such factors as inflation and increases in caseload. However, many formulas were suspended during the recession and some suspensions remain in effect. Other programs, such as the universities, do not receive automatic increases when costs rise or enrollment increases.
- While the JLBC projects ongoing revenues will equal ongoing expenditures in the current fiscal year, the general fund remains more than \$3 billion in arrears if fund transfers, payment deferrals, formula suspensions, inadequate funding of the BSF, and other factors are considered.

This chapter compares general fund revenue and appropriations. The data come from the JLBC. Chart IV-1 shows revenue and expenditures relative to personal income. In each measure, the cyclicity since FY 2000 is obvious, as is the downward trend since the early 1990s.

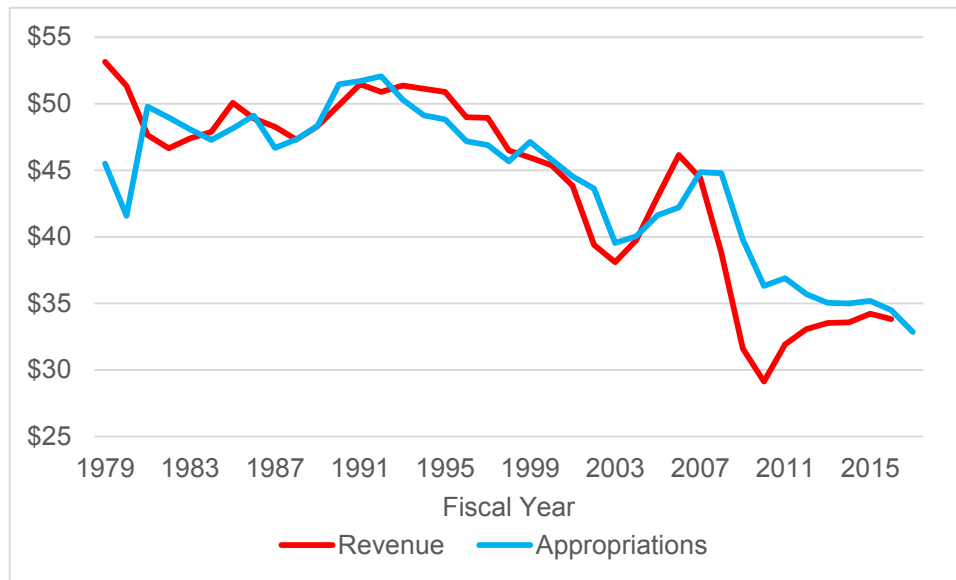
Surpluses and Deficits

As discussed in the introduction to this background report, cyclicity and budget deficits are key issues in government finance, particularly for Arizona state government’s general fund. All governments experience cyclicity in revenue tied to the economic cycle, which results in budget surpluses during years of strong economic growth and deficits in years of economic weakness.³²

In addition to cyclical surpluses and deficits, a government may experience a structural deficit independent from the cyclical pattern. A structural deficit in the Arizona state government general fund has been present for much of the last 40 years. This deficit has been created mostly by tax cuts not accompanied by spending reductions of the same magnitude, though increases in expenditures without raising additional revenue also have contributed. For example, part of the responsibility for K-12 school construction — the School Facilities Board — was added to general fund responsibilities in the late 1990s without any increase in general fund revenue.

³² For more information on cyclicity, see Chapter 10 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

CHART IV-1 ONGOING REVENUE AND APPROPRIATIONS PER \$1,000 OF PERSONAL INCOME, ARIZONA STATE GOVERNMENT GENERAL FUND



Note: Revenue is expressed after subtracting urban revenue sharing.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (revenue and appropriations) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

The calculation of the size of the structural versus cyclical deficit is subject to interpretation and varying assumptions.³³ Based on one set of assumptions, the Arizona general fund was roughly balanced in FY 2007, as a cyclical surplus of \$1.7 billion nearly offset a structural deficit of \$1.75 billion. The structural deficit increased to more than \$2 billion the next year due to the implementation of the latest tax cuts. As the economy swung from strong growth to deep recession, the cyclical surplus declined in FY 2008, leaving a total deficit of nearly \$1.4 billion. A cyclical deficit was experienced the next year and grew to nearly \$1.7 billion in FY 2010. Thus, due to the severe economic cycle, the cyclical component experienced a decline of more than \$3.3 billion between FY 2007 and FY 2010.

Without considering the legislative responses to the deficit in FYs 2008 and 2009, the total deficit rose to nearly \$3.8 billion in FY 2010. Compared to what expenditures would have been had reductions not occurred as a result of having to balance the budget, this deficit represented 38 percent of the budget.

As in prior cycles, an improving economy after 2010 began to reduce the cyclical deficits. At the same time, the revenue resulting from a temporary three-year increase in the sales tax rate that was passed by voters in May 2010 began to be realized. This temporary tax raised \$864 million in FY 2011, \$916 million in FY 2012, and \$962 million in FY 2013. In conjunction with other budget solutions utilized beginning in FY 2008 (discussed later in this chapter), the temporary tax raised enough revenue to not only offset the annual deficit, but to transfer some

³³ For more information, see Arizona State University, Morrison Institute for Public Policy, *Structurally Unbalanced: Cyclical and Structural Deficits in Arizona*, January 2011, https://morrisoninstitute.asu.edu/sites/default/files/content/products/MI-BMW_StructurallyUnbalanced.pdf.

money into the rainy-day fund and to create an end-of-year surplus in the general fund that was successively rolled into the following fiscal year. However, once the temporary tax expired, the end-of-year surplus successively became smaller and the structural deficit was again exposed.

Economic growth in Arizona remains weak relative to prior economic expansions. In early 2015, an overall deficit was projected for FY 2016, based on conservative revenue projections. In response to the projected deficit, the Legislature ordered further spending reductions and other budget solutions to be implemented in FY 2016. Actual revenue was much stronger than projected. Instead of a deficit, a cyclical surplus was realized, though much smaller in magnitude than in prior economic expansions.

The JLBC estimates a “structural balance” using a different definition: the difference between ongoing revenues and ongoing expenditures. This balance reflects both cyclical and structural considerations. A recent history is shown in Table IV-1. Despite significant reductions in expenditures — expenditures in FY 2012 were 18 percent less than in FY 2008 without considering inflation or population growth — a deficit remained. Part of the reason that a structural deficit persisted is that additional tax reductions were passed. Some were passed with a delayed implementation, even in the depths of the imbalance between general fund revenues and expenditures.

Preliminary figures for FY 2016 are very close to the projections shown in Table IV-1, which were made by the JLBC in spring 2016, with both revenues and expenditures slightly greater than anticipated. With the additional spending reductions in FY 2016 and with the expectation of continued spending constraint — increases in expenditures limited to active funding formula requirements and other obligations — the JLBC’s projections indicate that the structural balance would be marginally positive in FY 2017 and will become more positive in succeeding years. However, if economic growth slows, ongoing revenue could easily fall below ongoing expenditures.

Budget Stabilization Fund

As noted in the introduction, a budget stabilization fund was created in 1990 as a response to cyclical surpluses and deficits. The intent was to transfer monies from the general fund into the BSF during years of budget surpluses and to transfer monies from the BSF into the general fund during years of budget deficits.

Saving excess revenue during periods of cyclical surpluses discourages spending increases and/or revenue reductions that are not sustainable over an entire economic cycle. Transferring monies from the BSF into the general fund during periods of cyclical deficits reduces the need to cut spending or increase revenue. Spending reductions during recessions not only diminish the quality and/or quantity of public services at a time when many Arizonans are most in need of assistance, but also have a depressing effect on an already weak economy. Increasing public revenues during a recession also has a negative effect on the economy, though not as large as from spending cuts.

As originally designed, the BSF was to hold as much as 15 percent of the general fund budget, with a recommended amount to transfer to or from the BSF in each year based on a formula that compares recent economic performance to an average growth rate. However, the Legislature was given the authority to override the recommendation.

The BSF has been modified and weakened in various ways since it was first created. The 15 percent cap was lowered to 7 percent, the formula was modified, only once was the recommended amount transferred, and certain

TABLE IV-1
ONGOING REVENUE AND ONGOING APPROPRIATIONS,
ARIZONA STATE GOVERNMENT GENERAL FUND

Millions of Unadjusted Dollars

Fiscal Year Year	Ongoing Revenue	Ongoing Appropriations	Balance
2006	\$9,259	\$8,255	\$1,004
2007	9,624	9,548	76
2008	8,765	10,031	-1,266
2009	6,967	9,967	-3,000
2010	6,297	9,698	-3,401
2011	7,191	9,394	-2,203
2012	7,789	8,198	-409
2013	8,144	8,508	-364
2014	8,361	8,772	-411
2015	8,926	9,228	-302
2016	9,164*	9,256	-92
2017	9,370*	9,367	3

* Projected.

Note: Ongoing revenue is expressed after the subtraction for urban revenue sharing.

Source: Arizona Joint Legislative Budget Committee, FY 2017 *Appropriations Report*, page BH-18, <http://www.azleg.gov/jlbc/17AR/bh2.pdf>, and FY 2016 *Appropriations Report*, page BH-15, <http://www.azleg.gov/jlbc/16AR/apprrpttoc.pdf>.

expenditures were made from the BSF for purposes other than revenue stabilization. These changes have resulted in far too little money being put aside during years of budgetary surpluses to balance the budget during each of the two recessions that have occurred since the BSF was created.³⁴ Since the current expansion is within three years of record length, another recession is likely within the next few years.

The budget stabilization fund balance reached about \$670 million going into FY 2008, but the fund was depleted in FY 2009. Deposits into the BSF occurred in FYs 2012 and 2013. The current balance is about \$460 million, 5 percent of the general fund. An additional \$190 million could be transferred into the BSF and remain within the 7 percent limit. The preliminary FY 2016 ending balance in the general fund is \$222 million.

Budget Solutions

“Budget solutions” are defined as legislative actions taken to balance the general fund when a shortfall between revenues and expenditures is projected or occurs. The preferred solution is to transfer money from the BSF, but due to the inadequate balance in the BSF, the severity of the last recession, and a large structural deficit, a number of other budget solutions had to be deployed. An accounting of budget solutions enacted during the period from FYs 2008 through 2012, as well as actions taken from FYs 2013 through 2016, is provided by the JLBC.³⁵

³⁴ For more information on the budget stabilization fund, see Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, Chapter 17, November 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf. Also see Arizona State University, L. William Seidman Research Institute, *Ensuring That Arizona State Government’s Budget Stabilization Fund Serves Its Purpose*, June 2012, <https://wpcarey.asu.edu/sites/default/files/uploads/research/competitiveness-prosperity-research/Bsf6-12.pdf>.

³⁵ Arizona Joint Legislative Budget Committee, *Comprehensive Budget Solutions FY 2008 – FY 2016*, November 2015, <http://www.azleg.gov/jlbc/compbudgetsolutionsFY2016.pdf>.

Over the five fiscal years from 2008 through 2012, a total of \$13.4 billion in budget solutions were enacted, according to the JLBC's accounting. The annual amount of the budget solutions rose from \$1.4 billion in FY 2008 to \$3.6 billion in FY 2009 to \$4.8 billion in FY 2010. The amount dropped to \$2.6 billion in FY 2011 and \$1.0 billion in FY 2012.

The budget solutions took various forms, as seen in Table IV-2. One-time solutions accounted for two-thirds of the total, not including the temporary sales tax increase. Permanent spending reductions accounted for nearly 25 percent of the total, while permanent revenue enhancements accounted for only 3 percent.

The spending reductions were disproportionately spread across the uses of general fund revenue. Among the larger agencies, percentage reductions were particularly large to the community colleges, universities, School Facilities Board, and AHCCCS. The reductions were relatively small to K-12 education and corrections. In FY 2013, some of the spending reductions began to be restored. The JLBC states that \$0.6 billion of permanent spending increases occurred between FYs 2013 and 2015. However, additional funding reductions occurred in FY 2016.

Fund transfers, also known as "sweeps," refer to the shifting of money to the general fund from one of the many other state government funds. These other state funds include funds that receive appropriations and those whose funding is not appropriated. The budget stabilization fund is not included in this classification. Fund transfers have occurred in every fiscal year since 2008.³⁶ Large amounts were transferred in each fiscal year from 2008 through 2012. Transfers from FYs 2008 through 2016 totaled \$2.4 billion, including more than \$500 million from the Department of Transportation and nearly \$400 million from the Department of Administration. Transfers from the Department of Transportation included \$61 million from the state aviation fund and more than \$100 million from each of two funds: the statewide transportation acceleration needs fund and the state highways fund. Typically, the monies transferred to the general fund have not been returned to the other funds, leaving these funds less able to provide the public service for which they were intended.

Another means that has been used to balance the general fund budget is to delay payments due to certain state agencies until the following fiscal year. Interest generally is not paid on these payment deferrals, also known as "rollovers." A total of \$1.3 billion in rollovers was used as budget solutions from FYs 2008 through FY 2012. The payment deferral balance still was nearly \$1.2 billion going into FY 2016, but the rollovers for the Department of Child Safety, Department of Economic Security, and universities, totaling \$232 million, were eliminated by legislative actions taken in the spring of 2016. The remaining rollover of \$931 million is owed to the Department of Education.

The use of debt and lease-purchase financing accounted for \$2.1 billion of the \$13.4 billion in budget solutions between FYs 2008 and 2012. The JLBC divides this budget solution into three components:

- Asset sale and lease-back. The sale of 22 state-owned properties in FY 2010 resulted in revenue of just over \$1.0 billion. The title will transfer back to the state after 20 years of payments.
- Lottery revenue bonds. Revenue of \$450 million was raised in FY 2010. This debt is being repaid from the general fund's portion of lottery revenue and therefore represents foregone revenue in coming years.
- School Facilities Board Lease-Financing. The revenue received was \$527 million in FY 2009 and \$60 million in FY 2011.

³⁶ Arizona Joint Legislative Budget Committee, *FY 2003–2016 Fund Transfers*, September 2015, <http://www.azleg.gov/jlbc/FY03-16FundTransfers.pdf>.

TABLE IV-2
BUDGET SOLUTIONS, FISCAL YEARS 2008 THROUGH 2012,
ARIZONA STATE GOVERNMENT GENERAL FUND

	Billions	Share
TOTAL	\$13.4	100.0 %
Permanent Solutions	3.7	27.6
Permanent Spending Reductions	3.3	24.6
Permanent Revenues	0.4	3.0
One-Time Solutions	8.9	66.4
Savings Related to Federal Stimulus	2.7	20.1
Debt and Lease-Purchase Financing	2.1	15.7
Fund Transfers	1.9	14.2
Budget Stabilization Fund Transfers*	0.5	3.7
Rollover and Payment Deferral	1.4	10.4
Other One-Time Savings	0.3	2.2
Temporary Sales Tax**	0.8	6.0

* Transfers from the budget stabilization fund totaled more than \$700 million from FYs 2008 through 2010, but were partially offset by a deposit to the fund in FY 2012. Another deposit occurred in FY 2013.

** In response to a request for clarification regarding the temporary sales tax amount, the JLBC responded that all revenue figures in the budget solutions report reflect the budgeted value, not the actual amount. The budgeted temporary sales tax amount of \$825 million compares to an actual figure of \$865 million for FY 2011. According to the JLBC, "because the sales tax was viewed as ongoing for its three years of existence, it was treated like other permanent spending and revenue changes in the report and was only applied in its first year." The temporary tax raised \$916 million in FY 2012 and \$962 million in FY 2013.

Source: Arizona Joint Legislative Budget Committee, *Comprehensive Budget Solutions*, November 2015, <http://www.azleg.gov/jlbc/compbudgetsolutionsFY2016.pdf>.

A More Comprehensive Look

The accounting of the budget solutions does not include all relevant issues regarding the general fund budget. Many of the expenditures from the general fund are determined by funding formulas, most of which are specified in statute. While some formulas may reflect adjustments for inflation and caseloads, in other cases, the use of the term "formula" is misleading. For example, a statute may specify only that a fixed amount of money is to be spent each year. In FY 2016, spending resulting from funding formulas accounted for \$5.9 billion; the statutorily determined portion of the ongoing general fund budget was 64.2 percent.

According to the FY 2017 Appropriations Report, a number of funding formula suspensions remain in effect. Suspensions to the Department of Education account for 76 percent of the statutory total of \$493 million. Another \$157 million in building renewal funds (nonstatutory) has been suspended, with 82 percent affecting the universities.

Many state programs are not covered by a statutory funding formula, including all of the general fund appropriations for the Departments of Child Safety and Corrections and nearly all of the appropriations for universities. The absence of a funding formula for these activities means that the agency is not guaranteed a funding adjustment to cover increases in demand for the public service provided or to offset inflationary increases in agency costs. More than \$3.3 billion in FY 2015 appropriations were not statutorily protected. Some of these appropriations were in fact reduced in FY 2016 despite inflation and growth in caseloads.

Some of the budget reductions to state agencies really involved a shift in costs from state government to local governments. In other cases, payments to local governments were reduced and contributions to the state from local governments were increased. For example, the FY 2016 budget included five ways (such as a shift in operating costs of the Department of Juvenile Corrections to county governments) in which local governments were affected, with a total impact of \$55.6 million.

While the JLBC projects ongoing revenues will equal ongoing expenditures in the current fiscal year, and while the general fund's FY 2016 ending balance was about \$225 million, the general fund remains more than \$3 billion in arrears if fund transfers, payment deferrals, formula suspensions, inadequate funding of the BSF, and other factors are considered.

V. STATE GOVERNMENT REVENUE OTHER THAN THE GENERAL FUND, AND ITS USES

- Appropriations from funds other than the general fund have increased substantially since the early 1990s after adjusting for the state's growth, though the increase over the last decade has been small.
- A large portion of the increase in appropriations from other funds results from voter-approved initiatives to increase funding for early childhood development, K-12 education, and health programs.
- Despite the overall increase, appropriations to the Department of Transportation from other funds has dropped sharply.
- Total appropriations from the general fund and from other funds are subject to a constitutional limit calculated as a share of personal income. Appropriations have been substantially lower than the limit for a number of years.
- Authorized but not-appropriated funding totals \$22 billion in the current fiscal year, far greater than general fund appropriations of \$9.4 billion and appropriations from other funds that total \$3.6 billion.
- While total not-appropriated funding has increased relative to the state's growth, this is due to very large increases in some programs, including AHCCCS and the Department of Health Services. Not-appropriated funding has declined for many agencies, especially the Department of Transportation.
- The Highway User Revenue Fund is the largest of the funds other than the general fund. After adjusting for the state's growth, distributions from this fund have fallen significantly.

This chapter discusses state government finance other than the general fund. The data come from the JLBC. Data on appropriations from other funds and not-appropriated spending are available annually from the Appropriations Report. A time series of appropriations from FY 1989 through FY 2017 from other funds is available separately. However, complete revenue data for other than the general fund are not readily available.

Appropriations From Other Funds

While the general fund has multiple revenue sources and its revenue is used for multiple purposes, other state government funds are much narrower, generally relying on a specific source of revenue to fund specific programs. Taxes supply much of the revenue for these other funds, but user fees are more commonly used in other funds than in the general fund. An example is university tuition and fees, which are placed into a separate fund and are used only to support the universities. User fees consist of payments received from the public for specific public services that benefit the person charged.

In FY 2017, \$3.62 billion was appropriated from other funds. Appropriations from other funds rose 140 percent between FYs 1992 and 2017 relative to personal income, with most of this increase occurring by FY 2007. The increased use of other funds is in large part related to the voter-approved tax increases that were discussed in Chapter II.

Table V-1 shows the agencies receiving the greatest appropriations from other funds. Universities received the largest amount in FY 2017, accounting for nearly one-third of the total. Virtually all of the monies received by the universities from other funds come from the university collections fund, which consists of student tuition and fees. The Department of Transportation received the next-largest amount from other funds. While it received monies from nine funds, a high percentage came from the state highway fund. The Department of Transportation experienced a large drop in appropriations from other funds over both time periods shown in the table, contrary to the overall increase.

**TABLE V-1
APPROPRIATIONS BY AGENCY,
ARIZONA STATE GOVERNMENT FUNDS OTHER THAN THE GENERAL FUND**

	Fiscal Year 2017		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1992 to 2017	FYs 2007 to 2017
TOTAL	\$3,623,755	100.00 %	140 %	11 %
Universities	1,185,275	32.71	-	106
Dept. of Transportation	373,810	10.32	-53	-36
Dept. of Economic Security**	293,945	8.11	x	x
Dept. of Administration	236,000	6.51	-	5
Dept. of Education	233,395	6.44	-	213
AHCCCS*	215,013	5.93	x	x
Dept. of Child Safety**	178,139	4.92	x	x
Dept. of Public Safety	171,389	4.73	-2	113
Lottery	113,438	3.13	-34	21
Dept. of Environmental Quality	76,335	2.11	-	-13
Dept. of Health Services*	52,867	1.46	x	x
Dept. of Corrections	50,470	1.39	-	-13
Other	443,680	12.24	38	-4
Agencies as Structured in FYs 1992 and 2007:				
AHCCCS	177,996	4.91	-	-45
Dept. of Health Services	89,885	2.48	343	-9
Dept. of Economic Security	472,084	13.03	-	-23

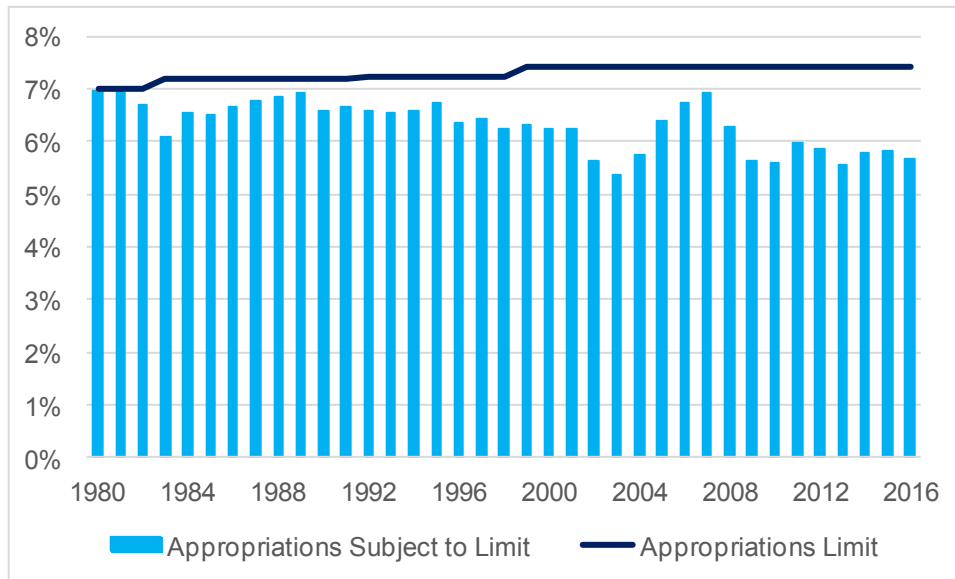
* A significant program, Behavioral Health Services, was transferred from the Department of Health Services to AHCCCS effective at the beginning of FY 2017. This invalidates the percent changes for these agencies. At the bottom of the table, the budget for Behavioral Health Services was subtracted from AHCCCS and added to the Department of Health Services so that comparisons over time could be made.

** The Departments of Economic Security and Child Safety were combined until FY 2014, precluding the calculation of the percent changes for these agencies. The two agencies are combined on the last line of the table.

Note: For percent changes shown as '-', the value for the earlier period was zero or near zero.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (appropriations) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

CHART V-1 APPROPRIATIONS AND APPROPRIATIONS LIMIT AS A PERCENTAGE OF PERSONAL INCOME, ARIZONA STATE GOVERNMENT



Sources: Arizona Joint Legislative Budget Committee, *State Appropriations Limit*, <http://www.azleg.gov/jlbc/appropslimit0216.pdf>.

The Arizona Constitution restricts the appropriation of certain state revenues to no more than 7.41 percent of Arizona personal income. This appropriations limit became effective in FY 1980. The applicable revenues are primarily tax and fee collections that may be deposited to either the general fund or other funds.^{37 38} As seen in Chart V-1, appropriations have been substantially lower than the limit for a number of years. In FY 2016, the appropriation figure was 5.66 percent of personal income. An additional \$4.77 billion could have been appropriated with the total remaining within the limit.

Not-Appropriated Funding

In FY 2017, authorized but not-appropriated funding amounted to \$22.02 billion. Most of the not-appropriated funding comes from the federal government and is designated to be used for a specific purpose.

Table V-2 shows the agencies receiving the greatest amounts of not-appropriated funding in FY 2017. AHCCCS received the largest amount, accounting for nearly 44 percent of the total. The universities and the Department of Economic Security also received substantial amounts.

³⁷ Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc/appropslimit0216.pdf>. The definition of the appropriations subject to the limit is broader than the sum of the appropriations from the general fund and from other funds.

³⁸ For a discussion of the appropriations limit and other constitutional limits, see Chapter 5 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

TABLE V-2
NOT-APPROPRIATED FUNDING BY AGENCY, ARIZONA STATE GOVERNMENT

	Fiscal Year 2017		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1992 to 2017	FYs 2007 to 2017
TOTAL	\$22,022,584	100.00 %	22 %	29 %
AHCCCS*	9,672,024	43.92	x	x
Universities	3,391,458	15.40	-18	44
Dept. of Economic Security**	3,232,287	14.68	x	x
Dept. of Education	1,780,751	8.09	5	-4
Dept. of Administration	1,018,811	4.63	-19	9
Lottery	628,863	2.86	-25	55
Dept. of Child Safety**	415,269	1.89	x	x
Dept. of Health Services*	315,130	1.43	x	x
Office of Economic Opportunity***	283,402	1.29	x	x
Early Childhood Development & Health	151,769	0.69	-	4
Transportation	108,890	0.49	-91	16
Dept. of Housing	95,132	0.43	-	-29
Other	928,799	4.22	-64	-65
Agencies as Structured in FYs 1992 and 2007:				
AHCCCS	8,218,631	37.32	142	50
Dept. of Health Services	1,768,523	8.03	516	42
Dept. of Economic Security	3,647,556	16.57	109	40

* A significant program, Behavioral Health Services, was transferred from the Department of Health Services to AHCCCS effective at the beginning of FY 2017. This invalidates the percent changes for these agencies. At the bottom of the table, the budget for Behavioral Health Services was subtracted from AHCCCS and added to the Department of Health Services so that comparisons over time could be made.

** The Departments of Economic Security and Child Safety were combined until FY 2014, precluding the calculation of the percent changes for these agencies. The two agencies are combined on the last line of the table.

*** New agency created in FY 2017.

Note: For percent changes shown as '-'; the value for the earlier period was zero or near zero.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (funding) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

Relative to personal income, total not-appropriated funding rose 22 percent between fiscal years 1992 and 2017, but the increase was 29 percent between fiscal years 2007 and 2017. The change over time varied substantially by agency, with large increases for AHCCCS, the Department of Health Services, and the Department of Economic Security, but a large decrease for the Department of Transportation.

Revenue Other Than the General Fund

A complete accounting of revenue sources for the 200+ state funds is not readily available from the JLBC. However, tax revenues are discussed in its annual Tax Handbook.³⁹

The highway user revenue fund (HURF) was the largest of these other funds in FY 2015, with revenue of \$1.29 billion. The preliminary figure for FY 2016 is \$1.36 billion. According to the JLBC, "HURF revenues are a major source of funding to the state for highway construction, highway maintenance and improvements, and other highway-related expenditures. A portion of HURF revenue is also distributed to Arizona cities, towns, and counties for highway-related purposes."⁴⁰ Other highway-related expenditures include "the cost of state enforcement of traffic laws" and "the cost of publication and distribution of *Arizona Highways Magazine*."

HURF receives revenue from a variety of taxes and fees; the following dollar figures are for FY 2015:

- \$370 million (45 percent) of the \$824 million raised from the vehicle license tax was placed in HURF; local governments are the other major beneficiary of this tax. The vehicle license tax is based on the assessed value of a vehicle; the tax is \$2.80 per \$100 of assessed value for new vehicles and \$2.89 per \$100 for renewals.
- HURF received \$471 million (96 percent) of the \$493 million raised by the motor vehicle fuel tax. This gasoline tax is levied at 18 cents per gallon.
- All of the \$185 million from the use fuel tax went to HURF. This tax is levied on diesel and other fuels, but not gasoline. The tax is 18 cents per gallon except that heavy vehicles pay 26 cents per gallon.
- Registration fees of \$169 million were placed in HURF.
- All of the \$40 million from the motor carrier fee went to HURF. The motor carrier fee is levied on vehicles weighing more than 12,000 pounds, with the amount based on the weight.
- Other fees contributed \$57 million to HURF.

Most taxes are levied as a percentage; collections from these sources rise with inflation. In contrast, some of the revenue sources for HURF are based on a flat fee, such as the gasoline tax at 18 cents per gallon. Collections from these sources do not keep pace with inflation.

The distribution of the \$1.29 billion in HURF monies in FY 2015 was as follows:

- State Highway Fund: \$496 million (38.5 percent of the total).
- Cities and towns: \$374 million (29.0 percent).
- Counties: \$233 million (18.1 percent).
- Controlled access: \$93 million (7.2 percent).
- Department of Public Safety: \$86 million (6.7 percent).
- Other: \$7 million (0.5 percent).

³⁹ Arizona Joint Legislative Budget Committee, annual *Tax Handbook*, <http://www.azleg.gov/jlbc/economicanalysis.htm>.

⁴⁰ Arizona Joint Legislative Budget Committee, *2015 Tax Handbook*, September 2015, page 179, <http://www.azleg.gov/jlbc/15taxbook/15taxbk.pdf>. The uses of transportation-related revenues are specified in Article 9, Section 14 of the Arizona Constitution.

The amount distributed in FY 2015 per \$1,000 of personal income was 22.5 percent less than in FY 2007 and 49.2 percent less than in FY 1993.

Other significant revenue sources outside of the general fund include the unemployment insurance tax (\$711 million in FY 2015), the voter-approved 0.6 percent sales tax dedicated to education (\$626 million), and the hospital assessment (\$250 million), which was enacted in 2014 to help support AHCCCS.

VI. TOTAL STATE GOVERNMENT REVENUES AND EXPENDITURES

- In fiscal year 2017, total authorized spending by state government totals \$35.1 billion.
- One-third of the spending is for AHCCCS. Another third goes to education, broadly defined to include all of elementary, secondary, and higher education.
- Total state government spending relative to the state's size has not changed much despite the sizable decline in general fund appropriations. Large increases in federal funding and voter-approved tax increases that are deposited to other funds have largely offset the decreases in legislative appropriations in the general fund.
- However, federal funding and the voter-approved tax increases are directed to specific programs and cannot be used to offset decreases in appropriations to other programs. Thus, sizable decreases in total authorized spending have occurred in many agencies, particularly the Department of Transportation. In contrast, very large increases were realized by AHCCCS and the Department of Health Services.

This chapter examines total state government revenues and expenditures, using data from both the JLBC and the Census Bureau.

Joint Legislative Budget Committee

The JLBC does not produce a comprehensive tally of revenue for all funds, but provides a total accounting of expenditures, including general fund appropriations, other fund appropriations, and not-appropriated monies.⁴¹ For FY 2017, appropriations from the general fund total \$9.43 billion. Appropriations from other funds total \$3.62 billion. The total appropriations of \$13.05 billion are considerably less than the not-appropriated amount of \$22.02 billion.

A small portion of the total of \$35.08 billion of state expenditures in FY 2017 are for capital outlays. The JLBC reports a total of \$1.56 billion in the capital outlay budget, of which \$552 million is appropriated — \$219 million from the general fund and \$333 million from other funds, mostly from the state highway fund.

Total authorized spending in FY 2017 for the largest state agencies is shown in Table VI-1. One-third of the total funding goes to AHCCCS. Education — defined broadly to include all of elementary, secondary, and higher education — also receives one-third of the total.

The distribution of funding by agency varies widely across the general fund, other funds, and the not-appropriated category. In FY 2017, AHCCCS is the largest recipient of not-appropriated monies; only 17 percent of total AHCCCS funding is appropriated. The Departments of Economic Security and Health Services also receive a high proportion of their total funding from not-appropriated sources, while the Department of Child Safety receives significant shares of its total funding from each of the three categories.

The Department of Education is the primary recipient of general fund appropriations in FY 2017, which accounts for two-thirds of total K-12 education monies. The School Facilities Board also receives a high proportion of its funding from the general fund. Universities are the primary recipients of monies from other funds, but this consists

⁴¹ See Arizona Joint Legislative Budget Committee, annual *Appropriations Report*, <http://www.azleg.gov/jlbc/budgetupdates.htm>.

almost entirely of tuition and fees paid by students. Close to 65 percent of the total funding for universities is not appropriated, including research grants and a variety of other types of funding. Most of these not-appropriated monies are restricted in use and cannot be used as a substitute for reductions in general fund appropriations.

The Department of Corrections receives 90 percent of its funding from the general fund in FY 2017. In contrast, more than three-fourths of the funding for the Department of Transportation comes from other funds, with hardly any appropriation from the general fund.

The percent changes over time in state government spending by agency expressed relative to personal income are shown in Table VI-2. Personal income is in part a function of population. However, if a caseload is changing at a rate different from the overall population, then the percent change relative to personal income is a less-than-ideal measure.

For example, between fiscal years 2007 and 2015 — the latest year of full-time-equivalent (FTE) enrollment data — enrollment at Arizona’s public universities rose 34.6 percent compared to an increase of 8.3 percent in the total population. If this large increase in the number of students is considered by measuring the inflation-adjusted change in funding per FTE student relative to per capita personal income, the percent changes over the FY 2007-to-2015 period are considerably different from those for funding per \$1,000 of personal income:

- General fund: a decline of 47 percent considering students versus 34 percent relative to personal income.
- Other funds: an increase of 65 percent considering students versus 105 percent relative to personal income. The 65 percent increase reflects the percent change in tuition per student relative to the ability to pay.
- Not appropriated monies: an increase of 12 percent considering students versus 39 percent relative to personal income. These monies generally are restricted to a specific purpose and therefore cannot be used to offset the loss of general fund monies.
- Total funding: an increase of 1 percent considering students versus 26 percent relative to personal income.

Total state government spending relative to personal income did not change much either between FYs 1992 and 2007 or between FYs 2007 and 2017 despite the large decreases in general fund appropriations.⁴² Appropriations from other funds increased substantially between FYs 1992 and 2007, while increases in not-appropriated funding were realized between FYs 2007 and 2017, reflecting voter-approved increases in certain tax rates in the former case and gains in federal funding in the latter.

While total state government spending relative to personal income hardly changed, sizable decreases occurred in most agencies in one or both of the time periods. In contrast, a very large increase was realized in each time period for the aggregation of AHCCCS and the Department of Health Services, resulting from large increases in not-appropriated monies.

⁴² Note that the first time period shown in the table is for FYs 1992 to 2007, while other tables in this report provide the figures for the entire FY 1992-to-FY 2017 period.

**TABLE VI-1
EXPENDITURES BY AGENCY, FISCAL YEAR 2017,
ARIZONA STATE GOVERNMENT**

	TOTAL		General Fund		Other Funds		Not Appropriated	
	Dollars in Thousands	Share of Total	Dollars in Thousands	Share of Total	Dollars in Thousands	Share of Total	Dollars in Thousands	Share of Total
ONGOING TOTAL	\$35,076,225	100.00%	\$9,429,885	100.00%	\$3,623,755	100.00%	\$22,022,584	100.00 %
AHCCCS	11,637,978	33.18	1,750,941	18.57	215,013	5.93	9,672,024	43.92
Dept. of Education	6,083,522	17.34	4,069,376	43.15	233,395	6.44	1,780,751	8.09
Universities	5,275,206	15.04	698,472	7.41	1,185,275	32.71	3,391,458	15.40
Dept. of Economic Security	4,056,356	11.56	530,124	5.62	293,945	8.11	3,232,287	14.68
Dept. of Administration	1,279,957	3.65	25,146	0.27	236,000	6.51	1,018,811	4.63
Dept. of Corrections	1,158,037	3.30	1,046,683	11.10	50,470	1.39	60,884	0.28
Dept. of Child Safety	972,588	2.77	379,179	4.02	178,139	4.92	415,269	1.89
Lottery	742,301	2.12	0	0.00	113,438	3.13	628,863	2.86
Dept. of Transportation	482,750	1.38	50	0.00	373,810	10.32	108,890	0.49
Dept. of Health Services	454,549	1.30	86,552	0.92	52,867	1.46	315,130	1.43
Dept. of Public Safety	380,461	1.08	121,196	1.29	171,389	4.73	87,877	0.40
School Facilities Board	317,168	0.90	228,094	2.42	0	0.00	89,073	0.40
Other	2,235,354	6.37	494,071	5.24	520,015	14.35	1,221,268	5.55
Largest Agencies in "Other":								
Office Economic Opportunity	284,471	0.81	1,069	0.01	0	0.00	283,402	1.29
Judiciary	182,011	0.52	113,018	1.20	41,162	1.14	27,832	0.13
Dept. Environmental Quality	156,647	0.45	2,824	0.03	76,335	2.11	77,489	0.35
Early Childhood Developmt	151,769	0.43	0	0.00	0	0.00	151,769	0.69
Attorney General	120,714	0.34	24,665	0.26	44,320	1.22	51,730	0.23
Game and Fish	109,248	0.31	0	0.00	42,239	1.17	67,009	0.30
Retirement System	105,649	0.30	0	0.00	27,484	0.76	78,165	0.35
Dept. of Housing	96,262	0.27	811	0.01	319	0.01	95,132	0.43
Dept. of Revenue	81,250	0.23	31,998	0.34	46,235	1.28	3,017	0.01
Community Colleges	72,513	0.21	54,313	0.58	0	0.00	18,200	0.08
Dept. of Emergency Affairs	65,166	0.19	12,620	0.13	0	0.00	52,546	0.24
Schools for Deaf & Blind	54,190	0.15	21,378	0.23	11,678	0.32	21,134	0.10
Legislature	53,571	0.15	51,380	0.54	250	0.01	1,940	0.01
Industrial Commission	41,735	0.12	0	0.00	19,881	0.55	21,854	0.10

Source: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm>.

TABLE VI-2
ONGOING EXPENDITURES BY AGENCY, PERCENT CHANGE PER \$1,000 OF PERSONAL INCOME,
ARIZONA STATE GOVERNMENT

	TOTAL		General Fund		Other Funds		Not Appropriated	
	FYs 1992 to 2007	FYs 2007 to 2017	FYs 1992 to 2007	FYs 2007 to 2017	FYs 1992 to 2007	FYs 2007 to 2017	FYs 1992 to 2007	FYs 2007 to 2017
ONGOING TOTAL	-4 %	6 %	-14 %	-27 %	116 %	11 %	-6 %	29 %
AHCCCS & Health Services	50	28	-22	-21	*	-36	82	49
Dept. of Education	0	-16	-4	-24	*	212	10	-4
Universities	-34	25	-42	-45	*	107	-43	44
Economic Security & Child Safety	-19	51	-35	-7	*	-23	-33	109
Dept. of Administration	-14	7	-65	-36	*	5	-25	9
Dept. of Corrections	8	-6	3	-5	*	-10	12	-25
Lottery	-51	49	-	-	-45	21	-52	55
Dept. of Transportation	-67	-29	-	-	-26	-36	-92	15
Dept. of Public Safety	-4	-7	15	-46	-54	114	81	-18
School Facilities Board	*	-60	*	-59	-	-	*	-63
Other	-9	-46	-39	-53	71	-5	3	-51

-: the value in both periods was zero or near zero.

*: the value in the first period was zero or near zero and the value in the second period was larger.

Note: Caution is urged in interpreting these percent changes for a number of reasons:

- The percent changes have not been adjusted for changes in caseloads.
- The dollar values on which the percent changes are calculated may be small. The values for FY 2017 are shown in Table VI-1.
- Some shifts in functions between agencies may have occurred. AHCCCS and the Department of Health Services are combined due to the magnitude of such a shift; the Departments of Economic Security and Child Safety have been combined for the same reason.
- A large or small change in one of the three categories may be the result of an opposite change in another category.
- The change in the other funds category for universities reflects a large increase in tuition, which consists of both an increase in tuition charged per student and a rise in the number of students. Changes in the not-appropriated category may reflect large changes in federal funding.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.state.az.us/jlbc.htm> (expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

The Department of Transportation in particular experienced large decreases in total funding in each time period. Other agencies with significant drops between FYs 2007 and 2017 include the School Facilities Board, the Department of Education, and the aggregate of smaller agencies. While universities experienced an increase between FYs 2007 and 2017, this was due to very large hikes in tuition and gains in not-appropriated funding.

Most state agencies experienced large losses in funding from the general fund in one or both of the time periods due to reductions in revenue resulting from the many changes in tax laws. Chapter II discussed the loss of general fund revenue due to the changes in the tax code since the early 1990s; the total effect was about \$4.07 billion in FY 2016. Chapter II also discussed the voter-approved tax increases that have benefited other funds, with more than \$900 million raised in FY 2015. The net is a loss of \$2.85 billion in state government revenue in FY 2015. This net figure, however, is misleading in that the revenue from the tax increases is restricted to specific uses and therefore is not a substitute for many of the tax cuts.

Census Bureau

The accounting system used by the Census Bureau is considerably different from that used by the JLBC. All state funds are combined by the Census Bureau; the latest data are for FY 2013. The Census Bureau classifies most state government activities as “general.” The exceptions are utilities (in Arizona, limited to electric power), liquor stores (not present in Arizona), and insurance trust. The latter includes employee retirement, unemployment compensation, and workers’ compensation.

A summary of state government revenue in FY 2013 is shown in Table VI-3. The focus of this analysis is general revenue since utility revenue is generated from charges to consumers and because insurance trust revenue is accounted for separately from other revenues, being received from employers and employees.

The federal government accounted for nearly 35 percent of total general revenue; a small amount of transfers from local governments also was present. Taxes accounted for 72 percent of the own-source revenue. The general sales tax was by far the largest source of tax revenue, followed by the individual income tax. These two sources accounted for nearly three-fourths of total tax revenue.

The Census Bureau labels the major source of nontax revenue as “current charges,” also known as user fees. Other than taxes, current charges accounted for most of the own-source revenue. The bulk of the current charges came from two sources: higher education (university tuition and fees) and hospitals.

The percent change in revenue relative to personal income also is shown in Table VI-3. Total general revenue was essentially unchanged between FYs 1993 and 2013 and between FYs 2007 and 2013, as increases in federal government funding offset decreases in own-source revenue. However, the revenue from the federal government is restricted to particular uses and therefore does not directly offset the loss of own-source revenue. The temporary sales tax increase boosted the FY 2013 revenue. If it is removed from the Census Bureau figures, total revenue fell 3 percent between FYs 1993 and 2013 and 4 percent between FYs 2007 and 2013.

**TABLE VI-3
REVENUE BY SOURCE, ARIZONA STATE GOVERNMENT**

	Fiscal Year 2013		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL GENERAL REVENUE	\$29,176,274	100.00 %	1 %	-1 %
From Federal Government	10,166,478	34.85	94	10
From Local Governments	414,045	1.42	-41	-2
Total Own Source	18,595,751	63.74	-12	-8
Taxes	13,471,690	46.17	-23	-17
Property	762,651	2.61	-29	-26
General Sales	6,472,777	22.19	-13	-13
Selective Sales: Motor Fuel	781,426	2.68	-39	-9
Selective Sales: Alcoholic Beverage	68,684	0.24	-49	-3
Selective Sales: Tobacco	315,428	1.08	78	-21
Selective Sales: Public Utilities	21,013	0.07	-94	-59
Other Selective Sales	547,380	1.88	19	11
Individual Income	3,397,707	11.65	-25	-19
Corporate Income	662,026	2.27	-18	-40
Motor Vehicle License	193,816	0.66	-72	-19
Other	248,782	0.85	-41	-9
Nontax Revenue	5,124,061	17.56	41	25
Current Charges	3,381,853	11.59	78	89
Education	1,869,466	6.41	16	26
Higher Education	1,842,705	6.32	15	26
Other	26,761	0.09	239	13
Hospitals	1,173,082	4.02	-	-
Highways	9,251	0.03	1018	-31
Airports	805	0.00	-	-13
Natural Resources	22,261	0.08	-64	-15
Parks and Recreation	22,801	0.08	142	-40
Housing & Community Development	4,937	0.02	-	145
Solid Waste Management	2,906	0.01	-80	-14
Other	276,344	0.95	33	21
Miscellaneous Revenue	1,742,208	5.97	1	-25
Interest Earned	323,913	1.11	-44	-59
Sale of Property	251,425	0.86	119	-2
Other	1,166,870	4.00	13	-8
OTHER REVENUE	7,771,412	100.00	16	22
Utility	32,894	0.42	-39	8
Insurance Trust	7,738,518	99.58	16	22
Unemployment Compensation	555,723	7.15	-35	41
Employee Retirement	6,667,026	85.79	48	25
Workers' Compensation	515,769	6.64	-60	-19

- The revenue in the first year of the period was zero.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

The decrease in tax revenue was greater than the drop in overall own-source revenue. The declines in tax revenues resulted from two factors: changes to tax laws — including reductions in rates and creation of tax exemptions and tax credits — and the weaker-than-average economy in FY 2013. Unlike tax collections, nontax revenue has increased over time, almost entirely due to increases in current charges. A number of current charge categories contributed to the increase, with the hospital category a major factor.

A summary of state government expenditures in FY 2013 is shown in Table VI-4. The focus here is general expenditures. The Census Bureau's accounting system puts all of the funding for elementary and secondary education in the local government classification, so the distribution of state government expenditures reported by the Census Bureau is very different from that of the JLBC. Public welfare, which includes AHCCCS, was by far the largest category, followed by higher education, which includes the revenue collected from tuition and fees.

General expenditures are divided by the Census Bureau into capital and noncapital categories. The capital outlays category includes the purchase of land and buildings, construction of buildings, and purchases of equipment. It accounted for only 8 percent of the total expenditures in FY 2013.

The percent change in expenditures per \$1,000 of personal income also is shown in Table VI-4. Relative to personal income, total general expenditures increased 7 percent between FYs 1993 and 2013 and 12 percent between FYs 2007 and 2013. The percent change in total general expenditures in each period was greater than the change in total revenue.

The percent changes vary considerably by expenditure category, in part due to variations in caseload growth across categories. Between FYs 1993 and 2013, most categories experienced a decline, but this was offset by large increases in public welfare, health, and hospitals.

TABLE VI-4
EXPENDITURES BY CATEGORY, ARIZONA STATE GOVERNMENT

	Fiscal Year 2013		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL GENERAL EXPENDITURES	\$19,540,815	100.00%	7%	12%
Education	4,547,996	23.27	8	23
Higher Education	3,631,654	18.58	-1	17
Other Education	916,342	4.69	70	52
Libraries	923	0.00	-94	-92
Public Welfare	8,215,971	42.05	31	16
Hospitals	683,817	3.50	190	768
Health	1,836,392	9.40	56	19
Employment Security	96,683	0.49	-28	62
Veterans' Services	9,933	0.05	152	62
Highways	1,261,142	6.45	-34	-10
Air Transportation	8,239	0.04	-49	18
Police Protection	220,146	1.13	-31	-19
Corrections	787,878	4.03	-23	-22
Protective Inspection and Regulation	131,754	0.67	-36	-23
Natural Resources	255,364	1.31	-45	-31
Parks & Recreation	52,379	0.27	-1	-55
Housing & Community Development	77,350	0.40	-	-5
Solid Waste Management	1,829	0.01	-90	-66
Financial Administration	300,229	1.54	-56	-27
Judicial and Legal	176,613	0.90	-20	-16
General Public Buildings	31,688	0.16	-52	-19
Other Administration	90,401	0.46	-22	14
Interest on Debt	498,304	2.55	-26	-5
Other	255,784	1.31	-48	-27
Total Capital Outlays	1,568,033	8.02	-16	6
Total Noncapital	17,972,782	91.98	9	12
OTHER EXPENDITURES	4,217,558	100.00	28	32
Utility	34,599	0.82	-55	0
Insurance Trust	4,182,959	99.18	30	32
Unemployment Compensation	664,539	15.76	-30	185
Employee Retirement	3,366,945	79.83	97	36
Workers' Compensation	151,475	3.59	-73	-67

- The expenditure in the first year of the period was near zero.

Note: Expenditures for K-12 education are classified by the Census Bureau as being made entirely by local governments. Higher education includes community colleges and universities. The "other education" category includes vocational-technical schools; schools for deaf, blind and handicapped; and adult education outside of school systems.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (expenditures), U.S. Department of Commerce, Census Bureau (population), and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

VII. LOCAL GOVERNMENT REVENUE

- Local governments consist of counties, municipalities (incorporated cities and towns), school districts, and special districts (such as for fire protection).
- State government shares revenue with some local governments. A portion of the income tax collected by the state is shared with municipalities through the urban revenue sharing program. Counties and municipalities receive part of the sales tax collected by the state. A portion of transportation-related revenue is shared with counties and municipalities. School districts receive a large share of their revenue from the general fund and other state funds.
- The revenue system varies by type of local government. Other than special districts, state-shared revenues are a significant portion of the total revenue of local governments. The property tax is the most important type of own-source revenue for counties and school districts. The largest source for special districts is user fees; the general sales tax and user fees account for similar shares of municipality own-source revenue.
- Total general revenue available to the aggregate of all local governments declined 19 percent between fiscal years 1993 and 2013 after adjusting for the state's growth, with most of the drop occurring after fiscal year 2007.
- After adjusting for the state's growth, local government revenue from the federal government and from the state government dropped considerably. Own-source revenue did not drop as much. Local government tax revenue declined, but the amounts collected from user fees have kept pace with the state's growth.
- Local governments have increasingly relied on the sales tax, pushing up local sales tax rates.

According to the 2012 Census of Governments, 674 local governments are present in Arizona:⁴³

- 15 counties.
- 91 municipalities (incorporated cities and towns).
- 242 independent school districts: 96 elementary school only, 15 secondary school only, 96 unified elementary and secondary school, and 35 other, including community colleges and vocational schools.
- 326 special districts: 313 exist for a single function, half of which are for fire protection. Other purposes are numerous and include hospitals, sewerage, flood control, and irrigation.

Government finance data for local governments are available only in aggregate as part of the state and local government finance series produced annually by the U.S. Census Bureau. The latest data are for fiscal year 2013.

However, the revenue system and the uses of revenue vary considerably by the type of local government. In order to investigate these differences, the census of governments for FY 2012 was examined. From this census, revenue and expenditure data are available separately for each type of local government: counties, municipalities, special districts, and school districts.

Revenue Sharing

Portions of the income tax and transaction privilege tax revenue collected by state government that otherwise would be deposited into the state general fund is shared with local governments, as is revenue that otherwise would be deposited in other state funds. The income tax sharing is through a program called urban revenue

⁴³ U.S. Department of Commerce, Census Bureau, 2012 Census of Governments, <http://www.census.gov/govs/cog/>

sharing, which was established by a 1972 ballot initiative. The amount shared with incorporated cities and towns currently is 15 percent of the income tax collections — both individual and corporate — from two fiscal years earlier. This amounted to \$606 million transferred to cities and towns in FY 2016. In its accounting, the JLBC places all of the income tax revenue in the general fund and enters the urban revenue sharing amount as a negative.

The sharing of TPT revenue is more complex. Unlike the income tax, not all of the TPT revenue is accounted for in the general fund. According to the JLBC, “Transaction privilege tax revenues are shared with Arizona’s counties and cities through a complex system of formulas established in statute. The Department of Revenue (DOR) transmits all sales tax revenues to the State Treasurer, separately accounting for payments of estimated taxes, the transient lodging tax, transaction privilege and severance taxes on mining and timber collected from businesses located on Indian reservations, and education sales taxes. The aforementioned tax collections have dedicated uses. All other sales tax revenues are credited to a clearing account. A portion of transaction privilege, severance, and jet fuel excise taxes referred to as the distribution base is designated for distribution to counties, cities, and other purposes pursuant to A.R.S. § 42-5029D4 ... After the required distributions to counties, cities, and other special purposes, remaining distribution base monies are credited to the General Fund ... The portion of sales tax revenues (non-shared) not designated to the distribution base is directly credited to the General Fund.”⁴⁴

In FY 2015, incorporated cities and towns received \$459 million from the shared portion of the state’s TPT. Counties received \$744 million.

As indicated in the box on the next page, counties and municipalities also receive a portion of the state’s revenue from transportation-related sources.

Revenue by Type of Local Government

The differences in the revenue sources used by type of local government are shown in Table VII-1. Other than special districts, each type of local government receives a substantial share of their general revenue from state government. The property tax is the most important type of own-source revenue for counties and school districts. The largest source for special districts is user fees; the general sales tax and user fees account for similar shares of municipality own-source revenue.

The JLBC provides an alternative accounting of school district revenues. It annually summarizes funding for K-12 education, taking into account all sources of revenue.⁴⁵ In fiscal year 2016, state government accounted for a little more than half of all funding, with the general fund alone accounting for 44 percent (see Table VII-2). Even with an increased payout in FY 2016, resulting from voter approval of Proposition 123 in May 2016, the permanent state school fund — funded from proceeds of the state land trust — accounted for less than 2.5 percent of the total.

In fiscal year 2016, inflation-adjusted funding per student was 8 percent less than in fiscal year 2008. All of the decline was in the state portion of the funding. The school district property tax provides the local funding.

To illustrate the challenges faced by local governments in financing their operations, two local governments —

⁴⁴ Arizona Joint Legislative Budget Committee, *2015 Tax Handbook*, September 2015, page 2, <http://www.azleg.gov/jlbc/15taxbook/15taxbk.pdf>.

⁴⁵ Arizona Joint Legislative Budget Committee, *K-12 Funding*, August 2016, <http://www.azleg.gov/jlbc/non-capitalfundingonly.pdf>.

Perspectives on Revenue Sharing

Ken Strobeck, Executive Director, League of Arizona Cities and Towns

The Arizona system of shared revenue with counties and incorporated cities and towns has been created through a series of voter initiatives and legislative actions dating back nearly 70 years. They were enacted based on the fundamental principle that having strong, stable local governments is in the best interests of the entire state. The system also provides a degree of uniformity since individual jurisdictions are prohibited from having their own local income tax systems and are preempted from enacting certain excise taxes.

A portion of the state-collected revenue is distributed from a variety of sources through formulas that are primarily based on jurisdictional population. Funds include state transaction privilege tax (sales tax), state income tax (distributed to cities and towns only), highway user revenue fund (HURF), and vehicle license tax (VLT). HURF funds are constitutionally restricted to solely street and road purposes but all other funds are considered general revenue and may be used for any governmental purpose.

For municipalities, shared revenue funds comprise approximately 40 percent of a typical community's general fund budget. This makes local governments highly dependent on tax policies adopted at the state level and subject to ups and downs of the overall state economic cycle. In rural communities that have few local retailers and may have little or no property taxes, shared revenue is critical to their very survival and provision of governmental services. The existence of shared revenue contributes to the comparatively low rates of property tax for local government in Arizona.

one a county and one a municipality — are highlighted after Table VII-2. The process of local government revenue collection was discussed in the Fall 2009 Town Hall background report.⁴⁶

Aggregate Revenue of All Local Governments in Arizona

The Census Bureau classifies most local government activities as “general.” The exceptions are utilities (water supply, electric power, gas supply, and transit), liquor stores (not present in Arizona), and insurance trust. The latter consists only of employee retirement at the local government level in Arizona. As explained in Chapter VI, the focus of this analysis is general revenue.

Relative to personal income, total general revenue available to local governments declined 19 percent between fiscal years 1993 and 2013, with most of the drop occurring after fiscal year 2007. These decreases contrast with state government general revenue, which hardly changed over either period. As seen in Chart VII-1, local government general revenue decreased substantially in fiscal years 2011 and 2012, due to declines in intergovernmental transfers and in a broad range of own-source revenues.

In fiscal year 2013, revenue transfers from the state and federal governments accounted for 36.5 percent of total local government general revenue, with the state government responsible for most of this intergovernmental revenue. Taxes accounted for 40 percent of all local government revenue, and 63 percent of own-source revenue. By far, the most important source of tax revenue to local governments in aggregate is the property tax. This complex tax is briefly described in the box on the following page.

⁴⁶ See Chapter 8 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf.

**TABLE VII-1
REVENUE SOURCES BY TYPE OF LOCAL GOVERNMENT,
ARIZONA, FISCAL YEAR 2012**

	Share of Total General Revenue				
	All	County	Municipal	Special District	School District
Intergovernmental	37.6 %	42.2 %	29.2 %	9.5 %	48.3 %
From Federal Government	4.2	6.4	7.1	3.8	0.7
From State Government	30.7	33.8	20.9	1.2	43.9
From Other Local Governments	2.6	2.1	1.2	4.5	3.8
Total Own Source	62.4	57.8	70.8	90.5	51.7
Taxes	39.9	41.4	39.3	33.2	41.2
Property	26.6	32.9	7.6	22.8	41.2
General Sales	10.4	5.5	25.6	6.2	0.0
Selective Sales	1.2	0.5	3.3	0.0	0.0
Other	1.7	2.4	2.8	4.2	0.0
Nontax Revenue	22.5	16.4	31.5	57.2	10.4
Current Charges	16.5	9.8	24.7	51.5	5.4
Education	2.1	0.0	0.0	0.0	5.4
Hospitals	3.4	0.3	0.0	42.3	0.0
Airports	1.9	0.0	5.4	0.9	0.0
Natural Resources	0.4	0.1	0.1	4.7	0.0
Sewerage	3.8	3.8	8.7	0.9	0.0
Solid Waste Management	1.9	0.3	5.4	0.0	0.0
Other	2.8	5.3	5.2	2.2	0.0
Miscellaneous Revenue	6.0	6.6	6.8	6.1	5.1
Interest Earned	1.0	1.7	1.5	0.9	0.2
Other	5.0	4.9	5.2	5.2	4.9

Source: U.S. Department of Commerce, Census Bureau, 2012 Census of Governments, https://www.census.gov/govs/local/historical_data_2012.html.

**TABLE VII-2
PUBLIC ELEMENTARY-SECONDARY EDUCATION CURRENT OPERATIONS
FUNDING IN ARIZONA**

	Fiscal Year 2016		FY 2008 to FY 2016 Inflation-Adjusted Percent Change Per Student
	Millions of Dollars	Share of Total	
TOTAL	\$9,029.8	100.0 %	-7.9 %
Federal	1,259.9	14.0	2.1
Local	3,071.7	34.0	2.8
State	4,698.2	52.0	-15.9
Permanent Fund	219.4	2.4	305.8
Proposition 301	536.9	5.9	-24.7
General Fund	3,941.9	43.7	-18.2

Note: The JLBC uses average daily membership instead of enrollment for the number of students.

Sources: Arizona Joint Legislative Budget Committee, <http://www.azleg.gov/jlbc/non-capitalfundingonly.pdf> (funding and number of students), and U.S. Department of Commerce, Bureau of Economic Analysis, http://www.bea.gov/iTable/index_nipa.cfm (GDP implicit price deflator).

Perspectives on Municipality Revenue

Tabatha Miller, Administrative Services Director, Lake Havasu City

Like many municipalities, fiscal year 2008 is the standard used to measure whether Lake Havasu City has recovered from the Great Recession. In FY 2008, the city's operating revenues were \$100.1 million. Seven years later in FY 2015, operating revenues were \$98.1 million. Revenues had dropped as low as \$88.1 million in FY 2009.

Not only has total revenue decreased but where the money comes from has changed. Today, the city is more reliant on local revenue sources. Together, utility revenues and local taxes make up the majority of the city's operating funds. In FY 2008, these two sources made up 60 percent of the city's operating revenues. Last year (FY 2015), these two sources provided 71 percent, an increase of \$9.3 million or 15 percent from FY 2008.

By comparison, intergovernmental revenues — the third-largest revenue source made up mostly of state-shared taxes — decreased by 15 percent over the same time period. In FY 2008, this category provided \$23.8 million or 24 percent of the city's operating revenues. In FY 2015, it provided \$20.3 million or 21 percent. This source had dropped to \$16.5 million or 18 percent of revenues in FY 2012.

The remaining sources — federal and state grants, investment earnings and miscellaneous, and local charges and fees — cumulatively decreased \$7.8 million from FY 2008 to FY 2015. Grants alone decreased 86 percent or \$6.3 million. In FY 2008, these smaller sources combined were 16 percent of the city's operating revenue but last year dropped to 8 percent.

Perspectives on County Revenue

James Menlove, Chief Audit & Financial Compliance Officer, Navajo County

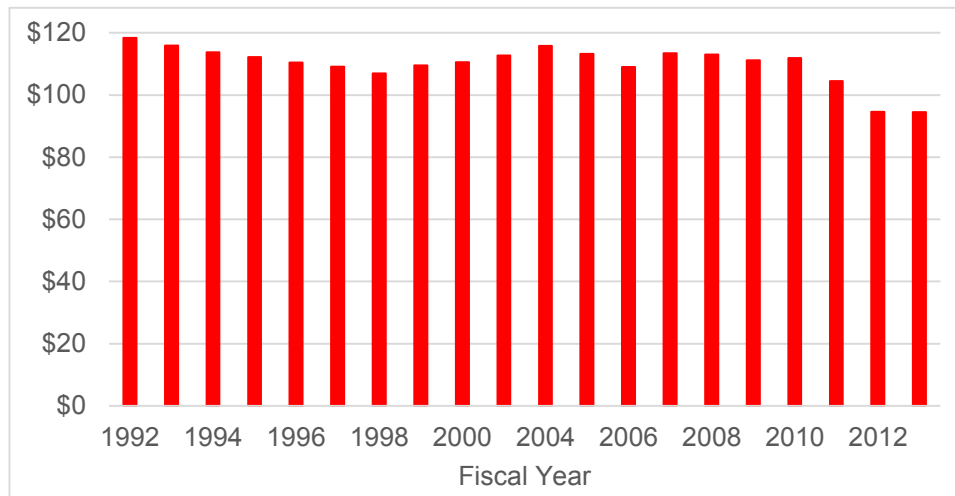
The effects of the Great Recession began to significantly affect Navajo County in the summer of 2009. In fiscal year 2008, the county's general fund revenue was \$32.8 million. In fiscal year 2010, however, general fund revenue dropped to \$28.3 million, a 12.5 percent decrease. Seven years after the onset of the recession, in fiscal year 2015, general fund revenue was recovering (\$32.4 million) but still was short of the prerecession level.

During this period of time, a few of the county's revenue sources remained fairly consistent: property taxes (\$6.8 million), court fines and fees (\$1.4 million), and federal payment in lieu of taxes (\$1.4 million). However, these sources provide only one-third of total general fund revenue. In addition, federal payments to counties are uncertain from year to year as they are reliant on an annual appropriation by Congress.

Revenue from the sales tax, the county's largest revenue source, declined significantly during the recession and has been very slow to rebound. In fiscal year 2008, state-shared sales taxes were \$10.9 million but dropped to \$8.9 million, an 18.4 percent decline, in fiscal year 2010. The county's local sales tax was \$7 million in fiscal year 2008 but fell to \$5.6 million, a 20 percent decline, in fiscal year 2010. Further, vehicle license taxes were \$2.3 million in fiscal year 2008 but decreased to \$2.0 million, a 13.0 percent decline, in fiscal year 2010. Finally, during the depths of the recession the state eliminated the county assistance fund, a loss of \$550,000 in lottery revenue sharing.

Highway and road maintenance has also experienced severe volatility. The county's allocation of Highway User Revenue Fund (HURF) dollars decreased from a high of \$9.3 million in fiscal year 2006 to \$7.5 million, a 19.4 percent decrease, in fiscal year 2010. Part of the reason for this declining revenue was a diversion of HURF dollars away from the county to the Arizona Department of Public Safety.

CHART VII-1 TOTAL GENERAL REVENUE PER \$1,000 OF PERSONAL INCOME, LOCAL GOVERNMENTS IN ARIZONA



Note: Data were not collected in fiscal years 2001 and 2003.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

The other major tax source is the general sales tax. Municipalities can levy their own TPT rate; use of the TPT by counties is more limited. The county rates range from 0.25 percent to 2 percent and the municipality rates range from 1.5-to-4.5 percent.

Local governments are precluded by state law from levying an income tax. Instead, cities and towns receive a portion of the income tax collected by state government.

Current charges accounted for most of the own-source nontax revenue (see Table VII-3). The larger sources for local governments in Arizona include sewerage, hospitals, solid waste management, and airports.

Own-source revenue accounts for a similar portion of total revenue in the state government and in the local governments of Arizona. However, the mix of sources differs considerably between the two levels of government. State government is somewhat more reliant on taxes, particularly on the sales tax and income taxes. Local governments are much more dependent on the property tax. The mix among current charges also differs considerably, with state government largely dependent on just two sources while local governments use a broader mix of user fees.

Perspectives on the Property Tax **Jennifer Stielow, Vice President, Arizona Tax Research Association**

If experts sought to design the ideal property tax system, they would not look to Arizona. In fact, Arizona's property tax system has long been recognized as one of the nation's most complicated as a result of its dual tax valuation structure and multiple property classifications. Although the recent passage of Prop 117 made modest steps to simplify the system, there is still much room for improvement.

Passed by the voters in 2012, Proposition 117 simplified Arizona's property tax system by reducing the number of taxable values from two to one and limiting the annual growth in taxable value to 5 percent. Rather than taxing property at its market value, or full cash value (FCV), government can only tax the limited property value (LPV). Additionally, this voter-approved measure traded the complicated two-tiered calculation that was used to determine the LPV for a simple annual increase capped at 5 percent, not to exceed the FCV. As a result, both primary taxes, which fund the maintenance and operations of local governments, and secondary taxes, which fund voter-approved bonds and overrides, are now levied only against the LPV.

Unlike most other states that assess property equally based on value, Arizona's property tax system classifies property into nine different classes based on current use and applies varying assessment ratios to each class, ranging from 1-to-18 percent. An ideal property tax system would be one that is equitable and simple for taxpayers to understand.

Relative to personal income, local government revenue from the federal government and from the state government dropped between fiscal years 1993 and 2013 and between FYs 2007 and 2013. Local government own-source revenue did not drop as much as revenue received from state government, but still fell 10 percent between FYs 2007 and 2013. Local government tax revenue also declined over time. Local governments have increasingly relied on the sales tax, pushing up local sales tax rates, accounting for the large gain between FYs 1993 and 2013. The decline in sales tax revenue between fiscal years 2007 and 2013 was a result of the severe economic recession and the succeeding slow recovery.

Unlike intergovernmental transfers and tax revenues, the amounts collected from current charges have kept pace with the growth in personal income. The change over time in the collection of user fees has varied by category.

**TABLE VII-3
REVENUE BY SOURCE, LOCAL GOVERNMENTS IN ARIZONA**

	Fiscal Year 2013		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL GENERAL REVENUE	\$22,940,116	100.00 %	-19 %	-17 %
From Federal Government	1,007,135	4.39	-25	-5
From State Government	7,365,818	32.11	-31	-29
Total Own Source	14,567,163	63.50	-10	-10
Taxes	9,184,720	40.04	-10	-8
Property	5,925,987	25.83	-26	-0
General Sales	2,551,028	11.12	59	-17
Selective Sales: Public Utilities	177,319	0.77	-23	2
Other Selective Sales	104,314	0.45	-28	-8
Motor Vehicle License	2,337	0.01	-87	-92
Other	423,735	1.85	77	-36
Nontax Revenue	5,382,443	23.46	-11	-12
Current Charges	3,783,677	16.49	11	-2
Education	471,085	2.05	-23	-21
Higher Education*	246,724	1.08	-27	-23
School Lunch Sales	89,341	0.39	-47	-32
Other	135,020	0.59	27	-7
Hospitals	794,769	3.46	47	3
Highways	4,214	0.02	-36	-42
Airports	440,901	1.92	-9	-16
Parking Facilities	3,757	0.02	-59	-16
Natural Resources	110,838	0.48	31	20
Parks and Recreation	109,165	0.48	-38	-3
Housing & Community Development	29,448	0.13	1	24
Sewerage	834,168	3.64	33	18
Solid Waste Management	463,618	2.02	9	10
Other	521,714	2.27	26	-13
Miscellaneous Revenue	1,598,766	6.97	-39	-30
Interest Earned	373,164	1.63	-77	-62
Special Assessments	61,489	0.27	-64	-56
Sale of Property	125,525	0.55	415	150
Other	1,038,588	4.53	33	-5
OTHER REVENUE	5,139,386	100.00	-17	5
Utility	4,671,800	90.90	-20	5
Water Supply	1,445,997	28.14	14	18
Electric Power and Gas Supply	3,109,846	60.51	-31	-1
Transit	115,957	2.26	500	50
Insurance Trust	467,586	9.10	21	-1

* For local governments in Arizona, consists of community colleges.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

VIII. USES OF LOCAL GOVERNMENT REVENUE

- Counties and municipalities are responsible for providing a broad range of public services. The largest categories of expenditures by counties in Arizona are related to crime: corrections, police protection, and judicial and legal administration. In municipalities, police protection is the largest expenditure, followed by fire protection.
- In contrast, special districts and school districts generally provide only one particular service.
- Total general expenditures made by the aggregate of all local governments dropped 23 percent between fiscal years 1993 and 2013 after adjusting for the state's growth, with most of the drop occurring after fiscal year 2007.

This chapter uses the aggregate local government data reported by the U.S. Census Bureau annually through fiscal year 2013. The 2012 census of governments provides information on expenditures by type of local government.

Expenditures by Type of Local Government

The differences in spending by type of local government are shown in Table VIII-1. Counties and municipalities are responsible for providing a broad range of public services. The largest categories of expenditures by counties in Arizona are related to crime: corrections, police protection, and judicial and legal administration. In municipalities, police protection is the largest expenditure, followed by fire protection. In contrast, special districts and school districts generally provide only one particular service.

Aggregate Expenditures of All Local Governments in Arizona

Per \$1,000 of personal income, total general expenditures made by local governments dropped 23 percent between fiscal years 1993 and 2013, and fell 18 percent between fiscal years 2007 and 2013. These decreases were in contrast to the increases in state government expenditures.⁴⁷ The declines in local government general expenditures were similar in magnitude to the decreases in local government general revenue. As seen in Chart VIII-1, local government general expenditures decreased substantially in each fiscal year after 2009, in response to the decrease in revenue that resulted from the 2008-10 recession and from the weak ensuing recovery.

As seen in Table VIII-2, education received more than 40 percent of local government expenditures in FY 2013. The Census Bureau classifies all elementary and secondary school funding as local; community colleges account for the higher education expenditures by local government. The remainder of the local government expenditures are spread across many categories, with police protection the largest of these, accounting for less than 9 percent of the total.

The expenditure mix for local governments is substantially different from that of state government. In addition to the differences in education, 42 percent of state government expenditures in FY 2013 went to public welfare, compared to only 1 percent of local government expenditures. Shares were higher for local government in a number of categories, including police protection, fire protection, and sewerage.

The percent changes per \$1,000 of personal income varied considerably across the local government expenditure categories between FYs 1993 and 2013 and between FYs 2007 and 2013. Some categories experienced increases despite the overall decrease in each time period.

⁴⁷ Using data from the JLBC, state government general fund expenditures also declined. However, state government spending from outside of the general fund rose, largely due to increases in funding from the federal government.

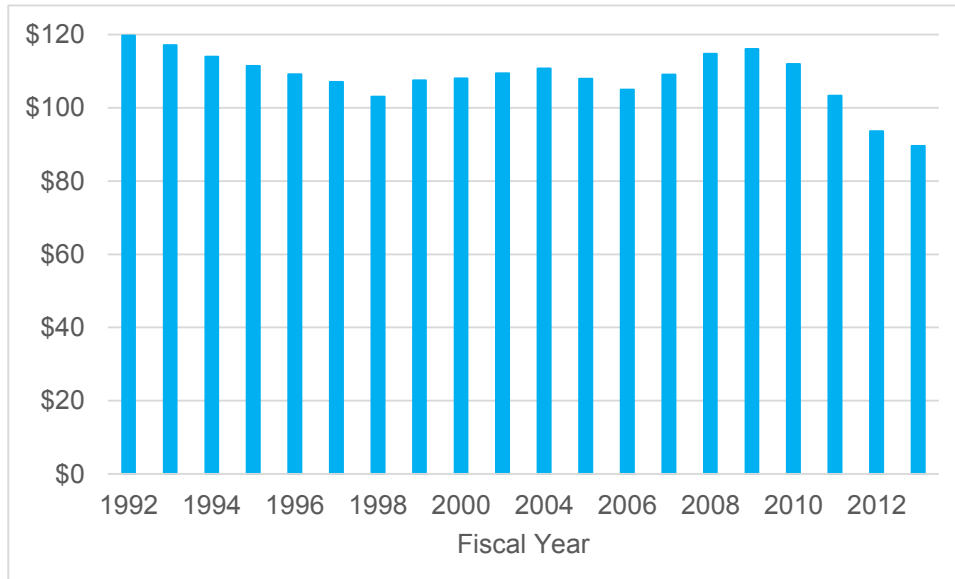
**TABLE VIII-1
EXPENDITURES BY TYPE OF LOCAL GOVERNMENT,
ARIZONA, FISCAL YEAR 2012**

	Share of Total General Expenditures				
	All	County	Municipal	Special District	School District
Higher Education*	6.0 %	0.0 %	0.0 %	0.0 %	14.2 %
Elementary and Secondary Educ	35.8	1.6	0.3	0.0	83.3
Libraries	0.7	1.8	1.2	0.0	0.0
Public Welfare	0.9	4.7	0.1	0.0	0.0
Hospitals	3.8	1.5	0.0	59.9	0.0
Health	1.2	6.3	0.1	0.6	0.0
Highways	4.5	8.9	8.5	0.0	0.0
Airports	2.6	0.0	7.4	2.7	0.0
Police Protection	8.3	10.0	19.5	0.0	0.0
Fire Protection	4.8	0.0	10.2	23.5	0.0
Corrections	3.0	15.1	0.5	0.0	0.0
Protective Inspection & Regulation	0.5	1.0	0.8	0.0	0.0
Natural Resources	1.1	2.7	0.1	9.9	0.0
Parks & Recreation	2.5	1.3	6.9	0.0	0.0
Housing & Community Developmt	2.2	0.7	6.3	0.0	0.0
Sewerage	4.1	8.1	7.5	1.9	0.0
Solid Waste Management	1.6	0.7	4.6	0.0	0.0
Financial Administration	1.1	2.3	2.1	0.0	0.0
Judicial and Legal	3.6	15.7	2.1	0.0	0.0
General Public Buildings	0.5	0.7	1.1	0.0	0.0
Other Administration	1.9	3.8	3.5	0.0	0.0
Interest on Debt	4.5	3.1	8.4	1.5	2.5
Other	4.7	10.0	8.7	0.2	0.0

* For local governments in Arizona, consists of community colleges.

Source: U.S. Department of Commerce, Census Bureau, 2012 Census of Governments, https://www.census.gov/govs/local/historical_data_2012.html.

CHART VIII-1
TOTAL EXPENDITURES PER \$1,000 OF PERSONAL INCOME,
LOCAL GOVERNMENTS IN ARIZONA



Note: Data were not collected in fiscal years 2001 and 2003.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (expenditures) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

**TABLE VIII-2
EXPENDITURES BY CATEGORY, LOCAL GOVERNMENTS IN ARIZONA**

	Fiscal Year 2013		Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL GENERAL EXPENDITURES	\$21,769,365	100.00 %	-23 %	-18 %
Education	8,907,717	40.92	-30	-18
Higher Education*	1,443,609	6.63	13	12
Elementary and Secondary	7,464,108	34.29	-35	-22
Libraries	164,284	0.75	-47	-17
Public Welfare	181,211	0.83	-84	-43
Hospitals	719,082	3.30	-10	-33
Health	238,149	1.09	-38	-10
Highways	1,006,432	4.62	-25	-38
Air Transportation	511,850	2.35	-7	-20
Parking Facilities	2,751	0.01	-93	-50
Police Protection	1,920,901	8.82	17	-5
Fire Protection	1,129,065	5.19	56	17
Corrections	642,495	2.95	5	-11
Protective Inspection and Regulation	85,879	0.39	-6	-57
Natural Resources	340,531	1.56	-27	5
Parks & Recreation	596,180	2.74	-24	-43
Housing & Community Development	492,894	2.26	-8	9
Sewerage	892,890	4.10	14	-34
Solid Waste Management	403,276	1.85	-2	1
Financial Administration	238,873	1.10	-48	-26
Judicial and Legal	811,016	3.73	-6	0
General Public Buildings	137,195	0.63	-27	-36
Other Administration	425,261	1.95	-2	-29
Interest on Debt	978,995	4.50	-57	0
Miscellaneous Commercial	14,221	0.07	-	188
Other	928,217	4.26	3	-18
Total Capital Outlays	3,013,057	13.84	-10	-20
Total Noncapital	18,756,308	86.16	-46	-41
OTHER EXPENDITURES	5,934,749	100.00	4	6
Utility	5,607,036	94.48	1	3
Water Supply	1,262,018	21.26	-14	0
Electric Power and Gas Supply	3,496,555	58.92	-7	8
Transit	848,463	14.30	209	-11
Insurance Trust	327,713	5.52	96	88

- The expenditure in the first year of the period was zero.

* For local governments in Arizona, consists of community colleges.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (expenditures), U.S. Department of Commerce, Census Bureau (population), and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

IX. REVENUE AND EXPENDITURE COMPARISONS TO OTHER STATES

- The total state and local government tax burden in Arizona of individuals and businesses combined is considerably below the national average. The tax burden had been equal to the U.S. average in the early 1990s.
- The individual tax burden in Arizona is substantially below average for those with high incomes, but is a little above average for those with low incomes. Arizona has one of the most regressive tax systems in the nation.
- For individuals overall, the income tax burden is very low in Arizona, but the sales tax burden is quite high.
- In contrast to the low individual tax burden overall, the business tax burden in Arizona is a little higher than the national average, and the highest among 10 western states.
- Businesses in Arizona pay comparatively high amounts in property taxes and sales taxes. Other business tax burdens, including the corporate income tax, are quite low.
- The state and local government own-source revenue system in Arizona is considerably different from the U.S. average. Arizona is heavily reliant on the general sales tax. Relative to the ability to pay, collections from this source are one of the highest in the nation. Arizona is far below average on each of the other significant tax sources and also is below average on nontax revenues.
- State and local government expenditures in Arizona in FY 2013 were far below average. On a per capita basis adjusted for the cost of living, expenditures were 23 percent below average, the lowest of all states. Relative to personal income, expenditures were 10 percent below average, 11th lowest in the nation.
- The expenditure mix in Arizona differs from the national average, with above average expenditures in some categories but far below average figures in other categories.
- Per student spending on K-12 education in Arizona in FY 2014 was the third lowest in the nation at 30 percent below average. The percent change in spending since the early 1990s was the second lowest in the nation.
- Per student spending on K-12 education is below average in every expenditure category; Arizona ranks near the bottom on administrative costs.
- Per student state and local government support for higher education also is considerably below average in Arizona. In FY 2015, the figure was 19 percent below average after adjusting for living costs, 10th lowest in the nation. Arizona ranks near the bottom in the percent change since the last recession.
- Due largely to the state's low incomes, the revenue capacity in Arizona is considerably below the national average. Even considering this low capacity, the state's revenue effort is below average.
- In contrast to the state's low revenue capacity, Arizona's fiscal needs exceed the national average. Yet its actual per capita spending in FY 2012 was second lowest in the nation.

The government finance comparisons across states discussed in this chapter are based on combined state and local government data. A number of data sources are used. Chapter I includes a discussion of the methods used to compare states.

Tax Burden

Numerous comparisons of the tax burden by state are available, but many of the studies are incomplete or otherwise unreliable. Most studies look at the total tax burden paid by individuals and businesses combined, but a few studies focus on either individual tax burdens or business tax burdens.⁴⁸

Total Tax Burden

The latest state and local government finance data from the U.S. Census Bureau are for fiscal year 2013 and include Arizona's temporary sales tax rate increase that was in effect from June 2010 through May 2013. State and local government taxes per \$1,000 of personal income were 10.1 percent less than the U.S. average in Arizona, ranking 14th lowest among the 50 states and the District of Columbia and third lowest among 10 western states.⁴⁹ On a per capita basis, Arizona was eighth lowest nationally and second lowest among the 10 western states at 25.6 percent below average.⁵⁰

The Tax Foundation provides a comparison of total state and local government taxes by state from 1977 through 2012 using a methodology different from that of the Census Bureau.⁵¹ In 2012, including Arizona's temporary sales tax, the total amount of taxes collected in Arizona was 8.8 percent of per capita income, 11 percent less than the national average of 9.9 percent. Arizona's figure was 15th lowest among the 50 states. Three of the western states had a lower figure: Texas, Nevada, and New Mexico. The historical comparison of Arizona to the nation is shown in Chart IX-1.

Individual Tax Burden

An annual study of state and local government taxes paid by individuals is produced by the government of the District of Columbia.⁵² For a hypothetical family of three living in the largest city in each state and the District of Columbia, the amount of state and local government taxes paid are calculated based on the applicable tax laws for four types of taxes at each of five income levels, ranging from \$25,000 to \$150,000. The latest data are for 2014.

Relative to the median of the 51 cities, total tax payments in Phoenix ranged from at least 13 percent lower at household income levels of at least \$100,000 to slightly higher at the lowest income level (see Table IX-1). The tax structure in Phoenix was more regressive than that of the median city. A study by the Institute on Taxation & Economic Policy indicates that the tax system in Arizona was the eighth-most regressive among the states.⁵³

⁴⁸ For a broad discussion of taxes, see Arizona State University, L. William Seidman Research Institute, *Overview of Economic Competitiveness: Business and Individual Location Factors, With a Focus on Arizona*, pages 56-63, November 2014, <https://wpcarey.asu.edu/sites/default/files/uploads/center-competitiveness-and-prosperity-research/competitiveness11-14.pdf>.

Also see Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, November 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf. The latter part of Chapter 9 addressed total and individual tax burdens, while Chapter 13 discussed business taxes.

⁴⁹ The 10 western states are Arizona, California, Colorado, Idaho, Nevada, New Mexico, Oregon, Texas, Utah, and Washington.

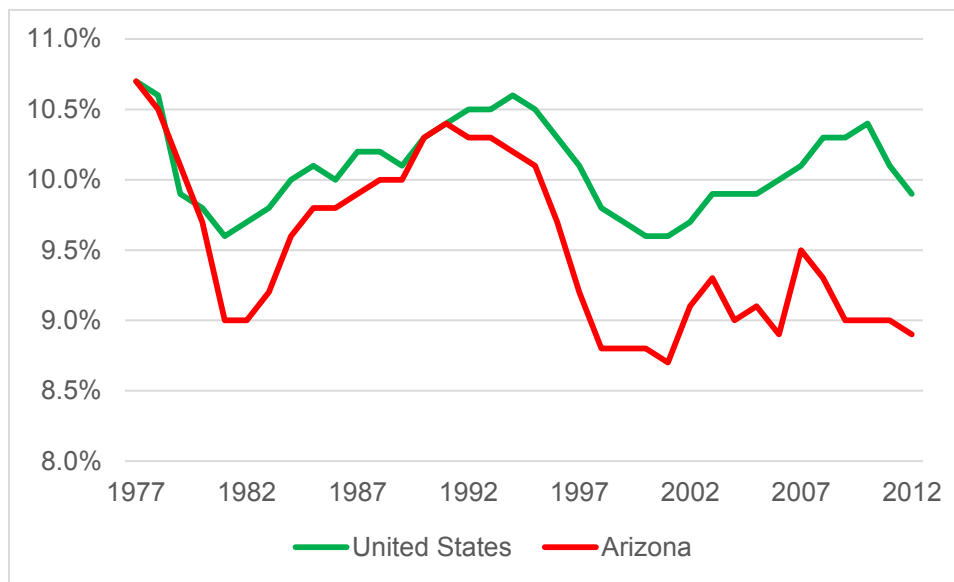
⁵⁰ The large difference between the per capita and per \$1,000 of personal income measures is due to the very low per capita personal income in Arizona. In 2013, per capita personal income in Arizona was 17 percent below the U.S. average, ranking 42nd nationally and seventh among 10 western states. After adjusting for the cost of living, per capita personal income in Arizona was 15 percent below the U.S. average, ranking 49th nationally and eighth among 10 western states.

⁵¹ Tax Foundation, *State-Local Tax Burden Rankings*, January 2016, <http://taxfoundation.org/article/state-local-tax-burden-rankings-fy-2012>.

⁵² Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia — A Nationwide Comparison*, 2014, December 2015, <http://cfo.dc.gov/node/215912>.

⁵³ Institute on Taxation & Economic Policy, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, January 2015, <http://www.itep.org/whopays/>.

**CHART IX-1
TAX BURDEN AS A PERCENTAGE OF INCOME,
STATE AND LOCAL GOVERNMENTS**



Source: Tax Foundation, State-Local Tax Burden Rankings, <http://taxfoundation.org/article/state-local-tax-burden-rankings-fy-2012>.

Individual income tax payments in Phoenix were less than half of the median of the cities at incomes of \$50,000 or more. Property tax payments were slightly above average except at the lowest income level. The amount of sales tax paid was very high in Phoenix.

Individual income taxes are examined in more detail in a study done by the Minnesota Center for Fiscal Excellence.⁵⁴ Forty-one states and the District of Columbia, including seven of 10 western states, levy an individual income tax. The Arizona figures for a married couple filing jointly are shown in Table IX-2; the results are similar for a senior married couple filing jointly, a head of household, a single person, and for a senior single filer. The results from this study are in line with those from the District of Columbia study, showing that individual income taxes in Arizona were very low from a national perspective at incomes of \$50,000 and more.

The income tax is progressive, with the amount due as a percentage of income rising with income. This partially offsets the regressive nature of the sales tax.

⁵⁴ Minnesota Center for Fiscal Excellence, *Comparison of Individual Income Tax Burdens by State, 2015 Edition*, October 2015, <https://www.fiscalexcellence.org/our-studies/income-tax-burden-study-2015edition-final.pdf>.

TABLE IX-1
TAXES PAID BY HOUSEHOLDS IN PHOENIX IN 2014

Tax Payment as a Percentage of the Median of 51 Cities and Rank Among 51 Cities Nationwide/10 Cities in Western States*

Household Income	Income Tax	Property Tax	Sales Tax	Automotive Taxes	Total
\$25,000	-%^ 18/3	94.8 % 31/8	131.6 % 12/2	101.8 % 25/5	103.0 % 24/4
\$50,000	45.5 38/6	111.1 21/4	132.6 12/2	105.1 21/4	94.8 30/4
\$75,000	44.0 39/6	110.9 22/4	133.5 11/2	130.2 14/2	90.9 34/5
\$100,000	46.1 39/6	108.6 22/4	131.8 12/2	113.7 16/3	85.2 37/6
\$150,000	48.4 39/7	100.6 25/6	135.8 10/1	185.4 12/2	86.6 37/6

* A rank of 1 indicates the highest tax payments.

^ The median is zero.

Source: Government of the District of Columbia, *Tax Rates and Tax Burdens in the District of Columbia — A Nationwide Comparison, 2014*, December 2015, <http://cfo.dc.gov/node/215912>.

TABLE IX-2
**INDIVIDUAL INCOME TAXES PAYABLE IN ARIZONA IN 2013,
MARRIED COUPLE FILING JOINTLY**

Income	Tax Due	Tax as Percent of U.S. Average	National Rank*	West Rank**	Tax as Percent of Income
\$20,000	\$-100	***	23	4	-0.50 %
\$35,000	357	101.1 %	21	3	1.02
\$50,000	762	56.1	36	5	1.52
\$75,000	1,329	55.0	39	6	1.77
\$100,000	2,055	55.6	40	7	2.06
\$150,000	3,400	54.7	41	7	2.27
\$250,000	6,836	59.1	41	7	2.73
\$500,000	17,888	69.6	39	7	3.58
\$1,000,000	35,358	63.3	39	7	3.54

* Among 42 states that levy the tax, where a rank of 1 indicates the highest tax payments.

** Among seven western states that levy the tax, where a rank of 1 indicates the highest tax payments.

*** The U.S. average also is negative.

Source: Minnesota Center for Fiscal Excellence, *Comparison of Individual Income Tax Burdens by State*, 2015 Edition, October 2015, <https://www.fiscalexcellence.org/our-studies/income-tax-burden-study-2015edition-final.pdf>.

Business Tax Burden

For most companies — those who serve local residents — taxes are not much of an issue. Such companies are subject to the same taxes as their competitors and taxes generally are passed on to the consumer, as are other costs, as part of the price of a good or service.

In contrast, business taxes are an issue for companies in the traded sector of the economy. Such companies sell their products primarily to customers outside the local area; their market area may be national or international. Communities nationally or internationally compete to be the home of such operations based on economic development location factors, including the local tax burden. However, the business tax burden is not one of the most important factors. In particular, the quality and availability of the labor force, the quality and availability of the physical infrastructure, and other costs — particularly labor costs — are more important than taxes.

All taxes paid by businesses are included in an annual study produced by Ernst & Young for the Council on State Taxation.⁵⁵ The study identifies six categories of business taxes: property, sales, excise (such as the motor fuel tax), income (corporate income tax plus the individual income tax when used for pass-through income by S corps), unemployment insurance, and license and other taxes (such as severance taxes). The amount of taxes paid by businesses during fiscal year 2014 was determined through a combination of detailed data collection and modeling. To compare states, the total amount of business taxes paid is divided by private-sector gross domestic product.

As seen in Table IX-3, the overall business tax burden in Arizona in FY 2014 was a little higher than the national average, in contrast to the lower-than-average individual tax burden (at income levels of \$50,000 and higher). Property and sales taxes paid by businesses were far higher than the national average, while the tax burden for each of the other business tax categories was substantially below average. As already-passed business tax cuts (mostly to the corporate income tax) continue to phase in over the next few years, Arizona's position relative to the rest of the country should improve somewhat.

Property taxes are examined in more detail in a study done by the Minnesota Center for Fiscal Excellence and the Lincoln Institute of Land Policy.⁵⁶ This study indicates that the tax burden of commercial and industrial property taxes in Phoenix relative to other large cities varies with the value of the property (see Table IX-4). Commercial property taxes were only slightly above average at low values but further above average at high values. Industrial property taxes ranged from below average at low values to substantially above average at high values. In contrast, residential property taxes were considerably below average at all values.⁵⁷

The Ernst & Young study indicates that the business share of state and local government taxes in Arizona was above the national average in FY 2014. This results more from the low tax burden on individuals than the slightly high burden on businesses. The business share of local taxes was considerably above the national average but the share of state taxes was only a little above average.

⁵⁵ Ernst & Young, *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2014*, October 2015, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=91531>.

⁵⁶ Minnesota Center for Fiscal Excellence and the Lincoln Institute of Land Policy, *50-State Property Tax Comparison Study*, April 2015, https://www.lincolninst.edu/pubs/dl/3550_2891_Pay_2014_PT_Report.pdf.

⁵⁷ The residential property tax comparison from this study is inconsistent with the finding from the District of Columbia tax study. Even at a city level, the property tax varies by property due to differences in school districts and special districts.

**TABLE IX-3
TAXES PAID BY BUSINESSES IN ARIZONA IN FISCAL YEAR 2014**

Tax	Share of Business Taxes		Business Taxes as a Share of Private-Sector Gross Domestic Product		
	United States	Arizona	Ratio To U.S. Average	National Rank*	West Rank**
TOTAL	100 %	100 %	105 %	19	1
Property	36	43	122	13	1
Sales	21	32	163	8	4
Income	14	8	56	45	8
Excise	12	9	80	38	8
License/Other	9	4	47	47	10
Unemployment Insurance	7	3	50	48	10

* Rank among 51 states, where a rank of 1 indicates the highest tax payments.

** Rank among 10 western states, where a rank of 1 indicates the highest tax payments.

Source: Ernst & Young, *Total State and Local Business Taxes: State-by-State Estimates for Fiscal Year 2014*, October 2015, <http://www.cost.org/WorkArea/DownloadAsset.aspx?id=91531>.

**TABLE IX-4
PROPERTY TAXES PAYABLE IN PHOENIX IN 2014**

Category and value	Ratio To National Average	National Rank*	West Rank**
Commercial, \$100,000	102.2 %	26	4
Commercial, \$1 Million	106.4	24	4
Commercial, \$25 Million	120.7	18	1
Industrial, \$100,000, 50% Personal Property	86.0	31	4
Industrial, \$1 Million, 50% Personal Property	126.3	13	2
Industrial, \$25 Million, 50% Personal Property	137.7	10	2
Apartment, \$600,000	60.6	44	6
Residence, \$150,000	73.4	36	6
Residence, \$300,000	70.3	39	7
Residence, Median Value	71.6	37	6

* Among 53 large cities nationwide, where a rank of 1 indicates the highest tax payments.

** Among 10 large cities in western states, where a rank of 1 indicates the highest tax payments.

Source: Minnesota Center for Fiscal Excellence and the Lincoln Institute of Land Policy, *50-State Property Tax Comparison Study*, April 2015, https://www.lincolninst.edu/pubs/dl/3550_2891_Pay_2014_PT_Report.pdf.

In addition, the Ernst & Young study looks at the issue of the amount of business taxes paid versus the benefits businesses receive from state and local government services. A number of assumptions must be made in pursuing such an analysis. Ernst & Young conclude that business taxes nationally are high relative to the services received, with Arizona similar to the national average in the extent to which the tax burden exceeds the value of the public services. Business taxes are discussed further in the following box.

Perspectives on Business Taxes **Kevin McCarthy, President, Arizona Tax Research Association**

For as long as federal, state and local policymakers have relied on taxes to support their budgets, they have also debated whether those tax burdens should fall on businesses or individuals. This is an area of public finance where there will always be some level of disagreement as the criteria for good tax policy does not exist in isolation of politics.

Arizona's tax system has most of the major taxes that businesses pay in other states. Historically, Arizona income and property taxes have been designed to fall more heavily on businesses than individuals. The current scheduled reductions in the corporate income tax rate will provide more neutrality in the income tax. Despite efforts to reduce the disparity between businesses and individuals, Arizona's property taxes still fall more heavily on businesses. While the incidence of Arizona's sales tax falls on business, it is passed through to individuals in most instances.

Determining an equitable imposition of taxes between businesses and individuals involves many considerations including benefits received, competitiveness, and accountability. The competitiveness of Arizona's tax system has been the subject of major debate at the State Capitol for the last 25 years as policymakers have attempted to create a tax system that does not deter economic growth and job creation. However, a less debated, but no less important, consideration when weighing business versus individual taxes is accountability. Accountability requires a strong link between those spending tax revenue (elected officials) and the voters electing them to office.

Revenue by Source

This section, and the following section on expenditures, is based on combined state and local government finance data from the Census Bureau for fiscal year 2013, with comparisons made to earlier fiscal years.⁵⁸ The revenue data are expressed per \$1,000 of personal income.

Arizona ranked 35th nationally on total revenue in FY 2013, with a figure 5 percent below the U.S. average. Revenue fell 3 percent between FYs 1993 and 2013 and 4 percent between FYs 2007 and 2013. On revenue received from the federal government in FY 2013, Arizona ranked in the middle of the states but above the national average, following gains over time (see Table IX-5). In contrast, Arizona ranked 40th on own-source revenue at 9 percent below average in FY 2013 following declines over time.

Taxes are the primary portion of own-source revenue; Arizona was 10 percent below average, ranking 38th in FY 2013, following declines over time. Of the primary sources of tax revenue, Arizona was below average by a significant degree on each source except the general sales tax. Including the temporary sales tax increase, Arizona was 59 percent above the national average and ranked fourth in the nation in FY 2013.

⁵⁸ For a broader discussion of how Arizona's revenue system compares to that of other states, see Chapter 14 of Arizona Town Hall, *Riding the Fiscal Roller Coaster: Government Revenue in Arizona*, 95th Arizona Town Hall Background Report, September 2009, http://www.aztownhall.org/Resources/Documents/95th_background_report.pdf. For a discussion of each revenue source, see Chapter 15 of the same report.

Current charges (user fees) account for the majority of own-source nontax revenue. Arizona was 7 percent below average and ranked 35th in FY 2013. On miscellaneous sources of revenue, including interest earnings, Arizona ranked 29th at 6 percent below average.

Expenditures by Category

In this section, the discussion of the FY 2013 expenditure data is based on per capita data adjusted for the cost of living. The percent change over time is expressed per \$1,000 of personal income. Table IX-6 also displays FY 2013 data per \$1,000 of personal income.

Arizona ranked last on total expenditures in FY 2013, with a figure 23 percent below the U.S. average. Total expenditures fell 12 percent between FYs 1993 and 2013, greater than the decrease in total revenue. Half of the decline in expenditures occurred between FYs 2007 and 2013.

In FY 2013, noncapital expenditures were 23 percent below the national average, the lowest in the nation. Capital outlays were 17 percent below average, the 12th-lowest figure in the nation. The decreases over time were larger for capital outlays.

In the two major expenditure categories, Arizona was 19 percent below average on public welfare (which includes AHCCCS) and 24 percent below average on education in FY 2013. Spending dropped between FYs 2007 and 2013 for education, but continued to rise for public welfare. In FY 2013, categories related to public safety — police protection, fire protection, and judicial and legal administration — were above average. Otherwise, Arizona's expenditures generally were below average. Given the significance of education among state and local government responsibilities, and the availability of caseload data (the number of students) by state, education is examined in more detail in the following two subsections.⁵⁹

Elementary and Secondary School Funding

The Census Bureau annually produces a report on K-12 public education finance by state, examining both revenues and expenditures. Private schools, including charter schools operated by nongovernmental organizations, are not included in the report. Data for fiscal years 1992 through 2014 are available online.⁶⁰ The following summary is based on per student revenues and expenditures adjusted by the cost of living.

Total revenue per student in fiscal year 2014 was 29 percent below the national average in Arizona, the third-lowest figure in the country. Federal revenue per student was 11 percent above average; state and local government revenue was 32 percent below average, also the third-lowest figure in the country.

On a per student basis adjusted by the cost of living, total expenditures in fiscal year 2014 were 30 percent below average, the third-lowest figure in the country. Expenditures were below average in every category (see Table IX-7). Between fiscal years 1992 and 2014, Arizona ranked next-to-last in the percent change in total expenditures, with among the smallest percent changes in each of the major categories.

⁵⁹ For a more detailed discussion of education funding, see Arizona State University, L. William Seidman Research Institute, *Government Revenues and Expenditures in Arizona*, pages 52-63, July 2015, <https://wpcarey.asu.edu/sites/default/files/uploads/center-competitiveness-and-prosperity-research/govtfin07-15.pdf>.

⁶⁰ U.S. Department of Commerce, Census Bureau, Public Elementary – Secondary Education Finances, June 2016, <http://www.census.gov/govs/school/>.

**TABLE IX-5
REVENUE BY SOURCE, STATE AND LOCAL GOVERNMENTS IN ARIZONA**

	Fiscal Year 2013		Fiscal Year 2013 Per \$1,000 of Personal Income			Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	Ratio To U.S.	U.S. Rank*	West Rank**	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL REVENUE	\$44,336,527	100.00 %	95 %	35	6	-3 %	-4 %
From Federal Government	11,173,613	25.20	110	27	5	33	14
Total Own Source	33,162,914	74.80	91	40	8	-11	-9
Taxes	22,656,410	51.10	90	38	8	-18	-13
Property	6,688,638	15.09	85	32	6	-26	-4
General Sales	9,023,805	20.35	159	4	3	-0	-14
Selective Sales:							
Motor Fuel	781,426	1.76	109	26	6	-39	-9
Alcoholic Beverage	68,684	0.15	60	32	6	-49	-3
Tobacco	315,428	0.71	100	32	4	78	-21
Public Utilities	198,332	0.45	40	38	8	-67	-12
Other	651,694	1.47	51	47	9	8	7
Individual Income	3,397,707	7.66	58	42	7	-25	-19
Corporate Income	662,026	1.49	72	34	6	-18	-40
Motor Vehicle License	196,153	0.44	45	49	10	-72	-27
Other	672,517	1.52	45	46	10	1	-28
Nontax Revenue	10,506,504	23.70	93	35	8	9	3
Current Charges	7,165,530	16.16	93	35	9	35	27
Education	2,340,551	5.28	115	25	4	5	13
Higher Education	2,089,429	4.71	118	25	4	8	18
School Lunch Sales	89,341	0.20	86	35	4	-47	-32
Other	161,781	0.37	96	24	4	42	-4
Hospitals	1,967,851	4.44	88	31	9	263	155
Highways	13,465	0.03	5	44	10	82	-35
Airports	441,706	1.00	124	11	4	-9	-16
Parking Facilities	3,757	0.01	8	48	9	-59	-16
Natural Resources	133,099	0.30	159	10	4	-9	13
Parks and Recreation	131,966	0.30	77	38	8	-29	-12
Housing & Development	34,385	0.08	32	51	10	18	33
Sewerage	834,168	1.88	95	22	7	33	18
Solid Waste Management	466,524	1.05	160	7	3	6	9
Other	798,058	1.80	71	34	7	29	-4
Miscellaneous Revenue	3,340,974	7.54	94	29	6	-23	-27
Interest Earned	697,077	1.57	79	36	6	-68	-61
Special Assessments	61,489	0.14	50	28	10	-64	-56
Sale of Property	376,950	0.85	591	2	1	171	23
Other	2,205,458	4.97	88	37	6	22	-6

* Among 50 states and the District of Columbia, where a rank of 1 indicates the highest revenue.

** Among 10 western states, where a rank of 1 indicates the highest revenue.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (revenue) and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income).

**TABLE IX-6
EXPENDITURES BY CATEGORY, STATE AND LOCAL GOVERNMENTS IN ARIZONA**

	Fiscal Year 2013		Fiscal Year 2013 Per Capita Adjusted for Cost of Living			Fiscal Year 2013 Per \$1,000 of Personal Income			Percent Change Per \$1,000 of Personal Income	
	Dollars in Thousands	Share of Total	Ratio To U.S.	U.S. Rank*	West Rank**	Ratio To U.S.	U.S. Rank*	West Rank**	FYs 1993 to 2013	FYs 2007 to 2013
TOTAL EXPENDITURES	\$41,310,180	100.00 %	77 %	51	10	90 %	40	7	-12 %	-6 %
Education	13,455,713	32.57	76	47	8	89	42	7	-20	-7
Higher Education***	5,075,263	12.29	96	34	8	112	24	5	2	15
Elementary & Secondary Education	7,464,108	18.07	65	50	10	76	49	10	-35	-22
Other Education	916,342	2.22	99	32	3	116	21	3	70	52
Libraries	165,207	0.40	70	40	8	82	38	8	-50	-21
Public Welfare	8,397,182	20.33	81	40	5	94	30	5	13	14
Hospitals	1,402,899	3.40	43	40	10	50	35	10	36	22
Health	2,074,541	5.02	118	15	3	138	9	1	33	14
Employment Security	96,683	0.23	98	35	5	114	28	5	-28	62
Veterans' Services	9,933	0.02	48	18	4	56	16	3	152	62
Highways	2,267,574	5.49	71	50	10	83	43	10	-31	-25
Air Transportation	520,089	1.26	122	13	4	142	7	3	-8	-20
Parking Facilities	2,751	0.01	7	48	8	8	48	8	-93	-50
Police Protection	2,141,047	5.18	105	14	3	122	7	3	9	-6
Fire Protection	1,129,065	2.73	129	7	2	150	3	1	56	17
Corrections	1,430,373	3.46	97	19	6	113	14	5	-13	-17
Protective Inspection & Regulation	217,633	0.53	76	30	7	89	21	7	-27	-41
Natural Resources	595,895	1.44	102	25	7	119	22	7	-36	-15
Parks & Recreation	648,559	1.57	85	30	8	99	23	8	-22	-44
Housing & Community Development	570,244	1.38	55	42	7	64	41	8	7	7
Sewerage	892,890	2.16	82	35	8	96	20	6	14	-34
Solid Waste Management	405,105	0.98	82	33	5	96	22	5	-6	0
Financial Administration	539,102	1.31	67	48	8	78	45	8	-53	-27
Judicial and Legal	987,629	2.39	115	12	4	134	8	4	-9	-3
General Public Buildings	168,883	0.41	61	42	8	72	37	7	-34	-33
Other Administration	515,662	1.25	89	36	7	103	24	7	-6	-24
Interest on Debt	1,477,299	3.58	68	38	8	79	31	8	-50	-1
Miscellaneous Commercial Activities	14,221	0.03	14	37	9	16	37	9	-	188
Other	1,184,001	2.87	46	47	9	54	46	9	-15	-20
Total Capital Outlays	4,581,090	11.09	83	40	8	97	28	5	-34	-35
Total Noncapital	36,729,090	88.91	77	51	10	90	41	7	-8	-1

* Among 50 states and the District of Columbia, where a rank of 1 indicates the highest expenditure.

** Among 10 western states, where a rank of 1 indicates the highest expenditure.

*** Higher education includes community colleges and universities.

- The expenditure in the first year of the period was zero.

Sources: U.S. Department of Commerce, Census Bureau, State and Local Government Finance, <http://www.census.gov/govs/local/> (expenditures); U.S. Department of Commerce, Census Bureau, <http://www.census.gov/popest/index.html> (population); and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (personal income and cost of living).

**TABLE IX-7
PUBLIC ELEMENTARY–SECONDARY EDUCATION EXPENDITURES IN ARIZONA**

	Fiscal Year 2014					Rank, Percent Change Over Time Per Student			
	Millions	Share of Total	Per Student Adjusted for Cost of Living			Fiscal Years 1992 to 2014		Fiscal Years 2007 to 2014	
			Ratio To U.S. Average	U.S. Rank*	West Rank**	U.S. Rank*	West Rank**	U.S. Rank*	West Rank**
TOTAL EXPENDITURES	\$8,101	100.0 %	70.1 %	49	8	50	9	49	9
Current Operations	7,222	89.1	70.1	49	8	48	9	45	7
Capital Outlays	678	8.4	75.7	38	7	47	8	47	9
Other Expenditures	201	2.5	54.9	34	7	48	10	41	10
Current Operations Detail:									
Instruction	3,903	48.2	62.7	49	8	51	10	47	8
Support Services	2,858	35.3	80.7	44	6	43	6	40	7
Pupil Support	546	6.7	96.8	26	4	21	2	32	4
Instructional Staff Support	409	5.1	88.2	35	6	19	3	1	1
General Administration	96	1.2	50.1	46	7	50	9	44	9
School Administration	329	4.1	59.5	51	10	50	10	51	10
Operations & Maintenance	854	10.5	88.9	39	3	38	5	46	8
Pupil Transportation	346	4.3	76.9	41	5	28	3	42	6
Other Support Services	279	3.4	78.0	32	7	28	6	48	9
Other Current Operations	461	5.7	86.3	39	4	25	5	30	6

* The rank is among the 50 states plus the District of Columbia, with a rank of 1 given to the highest ratio/greatest percent change.

** The rank is among 10 western states, with a rank of 1 given to the highest ratio/greatest percent change.

Sources: U.S. Department of Commerce: Census Bureau, Public Elementary–Secondary Education Finance, <http://www.census.gov/govs/school/> (expenditures and number of students), and Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (cost of living).

Higher Education Funding

Funding for higher education — community colleges and universities combined — is available from the State Higher Education Executive Officers Association. Data are available for fiscal years 2000 through 2015.⁶¹ On a per full-time-equivalent student basis adjusted by the cost of living, total state and local government appropriations in fiscal year 2015 were 19 percent below the national average in Arizona, and ranked 41st. In contrast, the tuition figure was above average (see Table IX-8). The percent change in appropriations between fiscal years 2008 and 2015 was one of the lowest in the country while the increase in tuition ranked among the top 10. The above average and rising tuition does not seem to be consistent with the Arizona Constitution. Article XI, Section 6 states “The university and all other state educational institutions shall be open to students of both sexes, and the instruction furnished shall be as nearly free as possible.”

Representative Revenues and Expenditures

Another way of comparing states is through the “representative revenue system” and “representative expenditure system” approaches. In the representative revenue system, “revenue capacity” (revenue-raising potential) is estimated by establishing a revenue base in each state and then applying a national average tax rate to that base. Measured on a per capita basis, revenue effort is calculated as actual revenue as a percentage of the revenue capacity.

In the representative expenditure system, “fiscal need” is estimated by applying a national average rate of per capita spending to the population of each state. The result is then adjusted for workload factors and other factors, such as input prices, that contribute to cost variations by state. Measured on a per capita basis, spending effort is calculated as actual expenditures as a percentage of the fiscal need.

Using FY 2012 data, the Urban Institute recently calculated revenue capacity and fiscal need by category for all states. The results for Arizona are shown in Tables IX-9 and IX-10.

Arizona’s overall revenue capacity per capita in FY 2012 was considerably below the national average, the fifth lowest in the country. The low capacity is due to a number of factors, but the low incomes present in the state are a primary cause. Actual revenue per capita in FY 2012 — third lowest in the nation — was further below the national average than revenue capacity. Thus, the revenue effort was below the national average. In other words, despite the low capacity, the state could have raised additional revenue without its revenue effort reaching the national average.

In contrast to the low overall revenue capacity per capita, Arizona’s overall fiscal need per capita in FY 2012 was greater than the national average, 11th highest in the nation. This too is due to a number of factors, including the state’s high poverty rate. Actual spending per capita in FY 2012 — second lowest in the nation — was far below the need. Thus, the spending effort also was far below average, with only one state having a lower figure.

The revenue capacity varied by source in FY 2012, though for most sources the capacity was below the national average. The revenue effort varied widely by source. Among the major revenue sources, the effort was quite high on the general sales tax but very low on the individual income tax.

⁶¹ State Higher Education Executive Officers Association, *State Higher Education Finance*, <http://www.sheeo.org/projects/shef-%E2%80%94-state-higher-education-finance>.

The fiscal need by category of spending ranged from somewhat above the national average to somewhat below. Actual spending was below the need in every category, but the spending effort was close to average in the police and corrections category. In contrast, the effort was very low — the lowest in the nation — for K-12 education. The fiscal need for K-12 education was high, fifth in the nation, while actual spending was very low, second lowest in the nation. Arizona also ranked very low on both actual spending and spending relative to the need in the highways, public welfare, and environment and housing categories.

**TABLE IX-8
PUBLIC HIGHER EDUCATION FINANCE IN ARIZONA**

	State Support	Local Support*	Education Appropriations	Net Tuition	Total Education Revenue
FY 2015 Dollars in Millions	\$916	\$808	\$1,487	\$2,038	\$3,431
FY 2015 Per Full-Time-Equivalent Student, Adjusted by Cost of Living					
Percentage of U.S. Average	48.9	375.2	80.8	128.3	100.6
Rank Among 50 States	49	1	41	21	33
Rank Among 10 Western States	10	1	8	3	2
Percent Change From FY 2000 to FY 2008, Per Full-Time-Equivalent Student					
Rank Among 50 States	25	4	17	19	18
Rank Among 10 Western States	7	2	5	4	5
Percent Change From FY 2008 to FY 2015, Per Full-Time-Equivalent Student					
Rank Among 50 States	50	20	47	7	36
Rank Among 10 Western States	10	7	10	5	7
Percent Change From FY 2000 to FY 2015, Per Full-Time-Equivalent Student					
Rank Among 50 States	49	6	38	7	23
Rank Among 10 Western States	10	2	9	3	5

* Unlike many states, public support for community colleges in Arizona predominantly comes from a property tax assessed by community college districts, accounting for the state's high figures in the "local support" column. In FY 2015, only 29 states used local funding to support higher education.

Notes:

- The figures include community colleges and universities.
- FY: Fiscal year.
- A rank of 1 indicates the highest funding or the greatest percent change.

Sources: State Higher Education Executive Officers Association, *State Higher Education Finance*, <http://www.sheeo.org/projects/shef-%E2%80%94-state-higher-education-finance> (finance data); and U.S. Department of Commerce, Bureau of Economic Analysis, <http://bea.gov/regional/index.htm> (cost of living).

**TABLE IX-9
REPRESENTATIVE REVENUES IN ARIZONA, FISCAL YEAR 2012**

	Per Capita Actual Revenue	Percentage of the National Per Capita Average		Revenue Effort	Rank, Revenue Capacity*		Rank, Actual Revenue*		Rank, Revenue Effort*	
		Revenue Capacity	Actual Revenue		U.S.	West	U.S.	West	U.S.	West
Total Revenue	\$4,920	82.4 %	75.9 %	92.1 %	46	9	49	9	39t	8
General Sales Tax	1,309	91.7	130.9	142.7	37	7	10	4	9	4
Property Tax	1,044	76.7	73.4	95.7	39	9	33	6	23	3
Individual Income Tax	472	79.7	48.3	60.6	45	9	42	7	41	7
Corporate Income Tax	99	75.6	63.5	83.9	40	7	36	5	31	5
Motor Fuel Tax	137	93.9	103.8	110.5	38	5t	24	5t	16t	5
Tobacco Tax	49	55.9	83.1	148.5	47	6t	33	4	17	2
Alcoholic Beverages Tax	10	102.1	21.3	20.8	31	6	45	8	44	8
Insurance Tax	65	75.0	116.1	154.8	42	4t	19	2	10	3
Severance Tax	6	110.9	10.9	9.8	16	6	23	7	30	9
Estate, Inheritance, and Gift Taxes	0	68.8	0.0	0.0	27	5	33	3t	41t	8
Lottery	31	49.3	43.7	88.6	40	6	37	5	34	6
Corporate Licenses	2	75.0	5.6	6.1	27	7	43	7	40	6
Hunting and Fishing Licenses	4	60.0	80.0	133.3	38	7t	30	7t	19t	9t
Motor Vehicle Registration	26	97.4	33.3	34.2	38	6	50	10	50	10
Motor Vehicle Operators Licenses	5	112.5	62.5	55.6	19	2t	36	7t	35t	9
All Other Taxes	149	83.2	40.3	48.4	42	7	45	9	44	9
Charges (User Fees)	1,065	83.1	78.4	94.4	42	7	43	10	31	8
Other Revenue	447	83.1	70.4	84.7	42	7	45	9t	40	8

* Rank among the 50 states and the District of Columbia and rank among 10 western states. A rank of 1 indicates the highest revenue.

** Actual revenue as a percentage of revenue capacity.

t: tie

Source: Urban Institute, *Assessing Fiscal Capacities of States: A Representative Revenue System-Representative Expenditure System Approach, Fiscal Year 2012*, www.urban.org.

**TABLE IX-10
REPRESENTATIVE EXPENDITURES IN ARIZONA, FISCAL YEAR 2012**

	Per Capita Actual Revenue	Percentage of the National Per Capita Average		Revenue Effort	Rank, Revenue Capacity*		Rank, Actual Revenue*		Rank, Revenue Effort*	
		Revenue Capacity	Actual Revenue		U.S.	West	U.S.	West	U.S.	West
Total Expenditures	\$6,442	103.7 %	76.3 %	73.5 %	11	4	50	9	50	10
Elementary & Secondary Education	1,205	111.0	66.9	60.3	5	4	50	9	51	10
Higher Education	727	98.8	88.0	89.1	25	6	35	8	34	8
Highways	356	93.5	69.8	74.6	38	7	48	10	42	9
Police and Corrections	540	103.7	101.9	98.2	18	2	15	5	18	7
Health and Hospitals	562	101.0	73.3	72.5	23	2	35	8	34	8
Public Welfare	1,241	109.5	80.3	73.3	11	2	41	5	44	8
Environment and Housing	453	99.5	72.5	72.8	24	6	45	9	46	9
Government Administration	307	98.9	88.0	89.0	24	6	36	9	33t	8
Other	788	99.3	69.5	70.0	24	6	36	8	37	8

* Rank among the 50 states and the District of Columbia and rank among 10 western states. A rank of 1 indicates the highest expenditures.

** Actual expenditures as a percentage of fiscal need.

t: tie

Source: Urban Institute, *Assessing Fiscal Capacities of States: A Representative Revenue System-Representative Expenditure System Approach, Fiscal Year 2012*, www.urban.org.

GLOSSARY

A

- Ability to pay:** the principle that taxes should vary according to an individual's level of wealth or income; also the capacity to pay for a tax
- Accountability:** a fiscal system guiding principle that refers to the linking of revenues and expenditures—changes in revenues and expenditures should be matched
- Appropriation:** a legislative act authorizing the expenditure of a designated amount of public funds for a specific purpose
- Arizona Health Care Cost Containment System (AHCCCS):** pronounced “access,” Arizona’s alternative to Medicaid
- Arizona Joint Legislative Budget Committee (JLBC):** legislative committee and staff that is responsible for oversight of the state budget
- Assessment ratio:** used in the calculation of the property tax liability, it is multiplied by the limited property value to determine the net assessed valuation; the assessment ratio varies by class of property, with the residential ratio 10 percent
- Authorized spending:** the sum of appropriations and not-appropriated spending

B

- Balanced budget:** a budget in which expenditures do not exceed revenues over a specified period of time
- Bond:** a debt to be paid back in a defined period of time at a specified interest rate
- Budget:** an estimation of the revenue and expenses over a specified future period of time
- Budget deficit:** an excess of expenditures over revenues; may result from a structural deficit and/or a cyclical deficit
- Budget solutions:** a term used by the JLBC for legislative actions taken to balance the general fund budget when a shortfall between revenues and expenditures occurs or is projected to occur; includes permanent solutions, such as reducing spending, and temporary solutions, such as transferring monies into the general fund from other funds and deferring payments
- Budget stabilization fund (BSF):** popularly called the “rainy-day fund,” a fiscal device used by state governments to store extra revenues during economic expansions for use in economic downturns when revenues are inadequate to meet public demands
- Budget surplus:** the amount by which revenue exceeds spending over a particular period of time
- Business taxes:** taxes imposed on the purchase, ownership, or use of inputs in a productive activity that are levied on businesses

C

- Capital:** financial assets or the financial value of assets such as cash, factories, machinery, and equipment
- Capital gain:** an increase in the value of a capital asset (particularly an investment or real estate) that gives it a higher worth than the purchase price
- Capital outlay (or expenditure):** funds spent for the acquisition or construction of a long-term asset, such as a building or a highway
- Caseload:** the number of cases handled by a public agency, such as the number of people enrolled in AHCCCS or the public schools
- Competitiveness:** one of the revenue system guiding principles: revenue policy should promote economic vitality and prosperity by equitably dividing the revenue burden between businesses and individuals

Constitution: fundamental laws and principles that prescribe the nature, functions, and limits of a government

Corrections: the various methods, such as incarceration, parole, and probation, by which society deals with convicted offenders

Cost of living: the average cost of food, clothing, and other necessary or usual goods and services paid by a person or family in a particular place

Counter-cyclical: cyclical movements contrary to those of the economic cycle; for example, increases in demand for public services when economic growth slows; contrast to “pro-cyclical”

Current charges: term used by the U.S. Census Bureau in place of “user fees”

Cycle: a recurring period of time in which certain events or phenomena repeat themselves; contrast to “trend” and see “economic cycle”

Cyclical deficit: a temporary deficit that occurs during weak economic conditions resulting mostly from a cyclical reduction in revenues, though a countercyclical demand for public services also may contribute; contrast to “structural deficit”

D

Debt: an amount of money borrowed and owed; part of a fiscal system

Debt finance: the acquisition of funds by borrowing, typically used to pay for the construction or purchase of long-lasting assets

Deficit: the amount by which expenditures exceed revenues over a specified period of time

Disproportionate share: a term used by the JLBC, the disproportionate share program provides supplemental payments of federal and state dollars to hospitals that serve a large, or disproportionate, number of low-income patients. Some of the revenue received from the federal government through this program is placed in the general fund and is used to pay for the increasing costs of AHCCCS

E

Economic cycle: a sequence of economic activity over a span of a few to several years typically characterized by recession, recovery, growth (expansion), and decline

Economic competitiveness: the competitiveness of a region is the productivity with which it utilizes its human, capital, and natural endowments to create value; also referred to as ‘business climate,’ the environment of a given community, as measured by location factors, that is relevant to the operation of a business

Economic development: the process and policies by which a region improves the economic and social well-being of its people

Efficiency: one of the revenue system guiding principles: revenue policy should have minimal impacts on economic behavior by using a broad tax base with low tax rates

Excise tax: selective sales taxes, such as the tax on motor vehicle fuel

Exportability: one of the revenue system guiding principles: nonresidents such as tourists should contribute to the revenues collected by governments

F

Fiscal: of or relating to government expenditures, revenues, and debt

Fiscal year: July 1 through June 30 for most governments

Full cash value: synonymous with market value; contrast to “limited property value”

Fund transfer: a ‘budget solution,’ refers to the shifting of monies into the general fund from another fund; also known as “sweeps”

Funding formulas: often specified in statute, funding formulas may reflect adjustments in funding for specific agencies based on inflation and changes in the caseload; many of the expenditures from the general fund are determined by funding formulas

G

General expenditures: as defined by the U.S. Census Bureau, government spending except that made by public utilities, liquor stores, and insurance trusts

General fund: the primary or catchall fund of a government, including all assets and liabilities that are not assigned to a special purpose fund

General revenue: as defined by the U.S. Census Bureau, taxes, user fees, and other income to all funds except utility, liquor store, and insurance trust

Government: the organization through which a political unit exercises authority and performs functions

Government finance: revenues, expenditures, and debt of a government; also known as public finance

Gross domestic product (GDP): the market value of goods and services produced by labor and property in the United States, regardless of nationality

H

Health and welfare: a category of government expenditures that consists of health programs (including Medicaid) and various assistance programs, such as nutrition assistance (formerly food stamps)

Highway user revenue fund (HURF): one of the many state government funds other than the general fund, it receives funding from motor vehicle fuel taxes and various other transportation-related taxes and fees, with expenditures limited to specified transportation-related purposes

Horizontal equity: equal treatment of people or businesses of equal means, one of the revenue system guiding principles

I

Income tax: tax levied on the gross income of individuals or on the net income of corporations and businesses

Inflation: an increase in the general level of prices, typically measured by the consumer price index or the gross domestic product implicit price deflator; the latter is used in this report

Infrastructure: the basic facilities, services, and installations needed for the functioning of a community, such as transportation and communications systems, power plants, and schools

Insurance premium tax: imposed on net insurance premiums received by insurance companies for risks that exist within the state

J

Joint Legislative Budget Committee: a part of the legislative branch of Arizona state government established in 1966, the JLBC ascertains facts and makes recommendations to the Legislature regarding all facets of the state budget, state revenues and expenditures, future fiscal needs, and the organization and functions of state government

L

Laffer curve: a relationship between tax rates and tax receipts indicating that rates above a certain level produce less revenue because they discourage taxable endeavors, and vice versa

Lease-purchase financing: purchase of an asset through periodic lease payments, which have principal and interest components

License tax: a fee paid to the government for the privilege of being licensed to do something, such as sell liquor

Limited property value: used in the calculation of the property tax due, it is multiplied by the assessment ratio to determine net assessed valuation; it is limited in the rate at which it can increase

Local government: counties, incorporated cities and towns, school districts, and special districts

Location factors: the environment of a given community that is relevant to the operation of a business; the most important factors are quality and availability of the labor force, cost of the labor force, and quality and availability of the physical infrastructure

Lottery: the Arizona Lottery is responsible for administering sanctioned games of chance; in addition to Arizona-specific games, the state also participates in multi-state Powerball and Mega-Millions on-line games

Luxury tax: a selective sales tax applied to tobacco products and liquor

M

Medicaid: federal and state government program for paying certain medical expenses of persons of low income; called AHCCCS in Arizona

Medicare: federal government program of hospitalization insurance and voluntary medical insurance for persons aged 65 and over and for certain disabled persons under 65

Municipality: an incorporated city or town

N

Neutrality: one of the revenue system guiding principles: differential treatment of similar economic activities should be minimized by limiting the number of tax credits and exemptions

Nominal: not adjusted for inflation; contrast to "real"

Nontraded sector: at a regional level, economic activities whose output in terms of goods or services are largely sold to customers within the region; the nontraded sector responds to growth in the traded sector

Not-appropriated spending: expenditures authorized but not appropriated by the Legislature, consisting largely of monies received from the federal government

O

Ongoing expenditure: as applied to the general fund, excludes any one-time spending

Ongoing revenue: as applied to the general fund, excludes any carry-forward amount from the prior year and any transfers from other funds

Own-source revenue: revenue realized by a government from its own tax levies, user fees, and other sources; excludes revenue transferred to it from another government

P

Per capita: per person

Per capita personal income: personal income divided by the number of residents

Per \$1,000 of personal income: revenue (or another measure) divided by personal income

Permanent fund: permanent state school fund created at statehood, largely consisting of monies received from the sale of public lands

Personal income: a measure of income produced by the U.S. Department of Commerce, it includes income received by persons from all sources: from participation in production as well as from government and business transfer payments

Personal property: furniture, equipment, and tools used for commercial purposes

Predictability: one of the revenue system guiding principles: taxpayers and policymakers both benefit from a revenue system that is changed infrequently

Private sector: the part of an economy in which goods and services are produced by individuals and companies, as opposed to the government

Pro-cyclical: cyclical movements consistent with those of the economic cycle; for example, decreases in revenues when economic growth slows; contrast to “counter-cyclical”

Productivity: the rate at which goods or services are produced, especially output per unit of labor

Progressive: a tax in which those with higher incomes pay a higher share of their income than those with lower incomes; contrast to “regressive”

Property tax: tax imposed on ownership of property and measured by its value

Proposition 301: approved by voters in November 2000, raising the general sales tax rate from 5.0 percent to 5.6 percent from July 2001 through June 2021; most of this revenue goes to K-12 education, with lesser amounts directed to the School Facilities Board and higher education

Public assistance: also known as public welfare or public aid, refers to the provision of a minimal level of well-being and social support for all citizens; includes such programs as Supplemental Nutrition Assistance Program (food stamps), Temporary Assistance for Needy Families, Medicaid, and Supplemental Security Income

Public safety: a category of government expenditures that includes police and fire protection, corrections, and inspection and regulation

Public sector: the part of the economy controlled by the government

R

Rainy-day fund: common term for a budget stabilization fund

Real: adjusted for inflation; contrast to “nominal”

Recession: a portion of the economic cycle, a period of economic contraction typically lasting from several months to a little more than a year

Regressive: a tax in which those with lower incomes pay a higher share of their income than those with higher incomes; contrast to “progressive”

Responsiveness: one of the revenue system guiding principles: revenues should grow at the same rate as the economy in the long term

Revenue: the income of a government from taxation, user fees, or other sources, which is appropriated to the payment of the public expenses

Revenue sharing: the sharing of revenue across governments; in Arizona, state sales tax and income tax revenue is shared with local governments

Rollovers: a ‘budget solution,’ refers to deferring payments to state agencies until the following fiscal year

S

S Corp: a closely held corporation in which the corporation’s income is divided among and passed through to its shareholders, who must then report the income on their own individual income tax returns

Sales tax: tax applicable with only specified exceptions (e.g., food and prescribed medicines) to sales of all types of goods (and sometimes services)

School Facilities Board: created in the late 1990s as part of the general fund, administers funds that provide capital funding for elementary and secondary school districts

Selective sales tax: taxes imposed on the sale of particular commodities or services apart from the general sales tax

Severance tax: a tax imposed by a state on the extraction of natural resources, such as oil, coal, or gas, that will be used in other states

Simplicity: one of the revenue system guiding principles: the revenue system should minimize the costs of compliance and administration

Special assessment: a tax levied by a local government on private property to pay the cost of local public improvements, such as sidewalk construction or sewage disposal, which are of general benefit to the property taxed

Special district: a political subdivision of a state established to provide a single public service, such as fire protection or sanitation, within a specific geographical area

Stability: one of the revenue system guiding principles: the year-to-year fluctuation in revenue over an economic cycle should be minimized

Statute: A law enacted by a legislature, contrast to “Constitution”

Structural balance: a term used by the JLBC for the difference between ongoing revenues and ongoing expenditures

Structural deficit: the deficit that remains across the business cycle because the general level of government spending is too high for prevailing revenues; contrast to “cyclical deficit”

Supply side: an economic theory that increased availability of money for investment, achieved through reduction of taxes especially in the higher tax brackets, will increase productivity, economic activity, and income

T

Tax: a charge imposed by legislative or other public authority upon persons, groups, or businesses for the support of a government

Tax base: the measure upon which the assessment or determination of tax liability is based — for example, taxable income is the tax base for the income tax and assessed value is the tax base for property taxes; the tax liability is calculated as the tax base multiplied by the tax rate

Tax burden: the ratio of tax revenues collected to some measure of income

Tax credit: an amount that may be subtracted from the sum of tax otherwise due and that is distinguished from a deduction applied to gross income in the calculation of taxable income

Tax cut: a reduction in taxation that may result from a reduction in the tax rate or the narrowing of the tax base, as by passing an exemption

Tax exemption: a deduction to the amount of income that is taxable, in contrast to a tax credit that reduces the actual amount of tax owed

Tax rate: the proportional amount of taxes paid on a given income, price, or dollar value of an asset

Traded sector: at a regional level, economic activities whose output in terms of goods or services are largely sold to customers outside the region; the traded sector drives the regional economy; contrast to “nontraded sector”

Transaction privilege tax (TPT): a general sales tax in which the seller is responsible for remitting the tax

Trend: the general course or prevailing tendency over time; contrast to “cycle”

U

Urban revenue sharing: passed by Arizona voters in 1972, specifies that a portion of income tax revenues be shared with incorporated cities and towns

Use tax: a state tax imposed on goods purchased outside a state for which state sales tax has not been paid

User fee: a charge for the use of something, such as a city government fee for garbage collection

V

Vehicle license tax: in Arizona, defined as a tax levied on vehicles based on value; as defined by the Census Bureau, various licenses and fees for title registration, license plates, etc.—the vehicle tax based on value is a property tax

Vertical equity: tax payments as a proportion of income should not be higher for those with lower incomes, one of the revenue system guiding principles



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