

**Report of the
109th ARIZONA TOWN HALL
“Financing Arizona’s Future”
Hilton Phoenix/Mesa, Arizona
November 13-16, 2016**

INTRODUCTION

"Taxes are how we pool our money for public health and safety, infrastructure, research, and services-- from the development of vaccines and the Internet to public schools and universities, transportation, courts, police, parks, and safe drinking water."

- Holly Sklar, author, syndicated columnist, policy analyst and strategist

Education, public safety, infrastructure, health care, social services and highways all have one critical common thread: they each rely on government finance. Regardless of how we might prioritize the critical issues facing our state, Arizona needs a well-functioning government finance system to address them adequately. Arizona’s current finance system depends heavily on sales tax and income tax. Our reliance on these revenue sources, combined with changes in the economy and statutory changes to the state tax code since the early 1990s, have resulted in an overall downward trend in government revenue compared to personal income. This means Arizona’s ability to deliver public services has not kept pace with the economy. In response, public services have been curtailed, more of the burden of providing services has been shifted to local governments and end users (e.g. tuition raises at universities and colleges, fund sweeps), the State Land Trust fund distribution has been increased to fund schools, and debt financing solutions have allowed us to delay addressing some of the structural and cyclical deficits we have experienced.

Set against this backdrop, participants in the 109th Arizona Town Hall traveled from throughout Arizona to convene in Mesa for four days to consider the topic of Arizona’s government finance system for the seventh time in Arizona Town Hall history. Participants addressed the effectiveness of Arizona’s current government finance system, the ways it might be improved to meet current and future needs, and challenges to implementing those changes. One of the biggest challenges the participants identified is that government revenue and the demand for government services is frequently counter-cyclical. That is, demand for services, such as enrollment in public assistance programs, rises when our economy declines and government revenues are correspondingly down. Other challenges include the failure to capture sales and use tax from Arizona’s growing service economy and the state budget limitations on governments carrying deficits into succeeding years.

The 109th Arizona Town Hall invited a robust, respectful policy discussion and participants hope their recommendations will inspire and motivate our state’s leaders to respond to these challenges. The results of the discussions at the 109th Arizona Town Hall are included in this report. Though not all Town Hall participants agree with each of the conclusions and recommendations, this report reflects the overall consensus reached at the 109th Arizona Town Hall.

Principal Statewide Needs

Education, healthcare, public safety, social services, and infrastructure are the principal needs that the Arizona government financing system should address. These needs include preschool through university education and vocational training; corrections; police and fire protection; water resources; transportation, telecommunications and water infrastructure; and behavioral and physical health services. We also need to recognize that there is both an urban and a rural Arizona which have their own unique requirements.

By funding these priority initiatives, Arizona will produce an educated workforce and quality of life that attracts and retains businesses and jobs to encourage and support statewide growth. We will keep quality teachers in the state and provide for affordable post-secondary education. We will ensure that Arizona is a safe place to live. We will ensure that we have adequate water resources and infrastructure to meet our needs.

Addressing Today's Needs

Arizona is a low-tax state and has implemented statutory and constitutional provisions that have cut taxes and made it very difficult to increase public revenue. At the same time, that revenue is highly dependent on cyclical income and sales taxes and is not keeping pace with the counter-cyclical demand for public services. This counterpoint makes it very challenging for Arizona to function nimbly during economic downturns.

We have seen public investment in infrastructure postponed, experienced some of the highest increases in tuition for post-secondary education, shifted funding responsibilities from the state to counties, municipalities, school and other local districts, and we have generated structural deficits that will ultimately have to be remediated.

Looking to the Future

The current government financing system is ill-equipped to meet Arizona's long-term needs. To attract and retain the people we need to enhance our statewide productivity and competitiveness, we need to adopt a long-term and sustainable perspective on spending priorities based on a state-wide strategic plan incorporating workable objectives and actionable metrics. Critical needs including education, infrastructure and health services are best addressed on a multi-year basis and need to be viewed as investments in our future. For example, water policies need to take at least a 50-year outlook to make certain we provide the requisite stewardship for this essential resource.

To ensure stability and predictability, we need to ensure that the budget stabilization fund ("rainy day fund") is properly structured and implemented to address the cyclical aspects of Arizona's financing structure in economic downturns. We should look at the existing legal constraints on increasing public revenue and ask if they need to be reconsidered in light of our growing needs and our decreased ability to pay for those needs.

We need to look at creative alternatives to meeting our financial needs including tax increment financing, public sector consolidation, and examine changes to existing tax policies related to property taxes. Further, we must broaden the tax base while simplifying Transaction Privilege Tax (TPT) regulations. We also need to lobby the Federal government to fully fund payment in lieu of taxes (PILT).

Factors Shaping Arizona's Financing System

Arizona's current financing system is characterized by a heavy reliance on income and sales taxes, prioritization of short-term political goals rather than long-term planning strategies, an overall focus on minimizing taxes, and statutory and state constitutional limits on our ability to raise revenues. These characteristics reflect some of Arizona's citizenry's preference for individual rights and smaller government. These preferences have evolved, at least in part, from Arizona's largely rural and land-centric historic economic drivers, such as copper, cotton, citrus, cattle, and climate. However, decades of tax cuts have not produced the anticipated economic boom.

Arizona is now experiencing shifts in its demographics and economy that will shape our government financing system in the future. First, our growing population is becoming more racially, socio-economically and culturally diverse. We have an increasing number of elderly residents and children, combined with a decreasing working-age demographic. In addition, our population is shifting from being largely rural to being highly urbanized. These changes affect our overall and per capita demand on government resources as well as our priorities for allocating government resources. Arizona is also experiencing changes in our economy with a greater part of our economy devoted to services and with more sales of goods occurring over the Internet where taxation is difficult to enforce. By not realizing transaction taxes on these sales, we are foregoing a significant revenue source that was formerly captured by brick and mortar retailers.

Arizona's government financing system is both affected by and affects our ability to generate economic development. Our inability to supply a workforce with the skills needed by businesses directly affects our ability to compete globally in attracting and retaining quality employers who supply higher income jobs. As such, Arizona has lost higher-wage jobs and been challenged to attract and retain talent within the state. Further, our low per-pupil spending on education scares away families from moving to Arizona and joining our workforce. Consequently, government revenue has declined along with per capita income relative to the national average and Arizona has struggled to address the wants and needs of its population. To reverse this trend, Arizona needs to focus on attracting more high-wage jobs, which will increase the tax base and improve collections through a stronger, more robust economy.

Arizona's electorate needs to become better informed about Arizona's government financing system, invested in the state, and involved in pushing civic leaders, including business and political leaders, to represent and advocate for the state's long-term future. Arizona also needs to change the electorate's attitude about taxes through education, transparency, and accountability and we need to advance the electorate's comprehension of the tax system. Going forward, Arizona's government financing system must be the product of all Arizonans coming together to define the priorities of the state.

Guiding Principles

Arizona's government financing system should follow a set of comprehensive, guiding principles rather than be driven primarily by short-term objectives and special interests. The guiding principles should include transparency, openness, fairness, simplicity, stability, accountability, and predictability. Arizona's government finance system should implement a long-range strategic vision that eliminates structural deficits and be transparent so that citizens can understand where their tax dollars are being spent. Government revenue should be sourced more broadly rather than relying so heavily on income and sales taxes. Taxation should also be established with an eye toward other western states to promote equity along with competitiveness.

Taxation should treat urban and rural constituencies equitably. We need to ensure that growth and downward economic cycles are anticipated and taken into consideration. Tax policy should be vertically and horizontally equitable. Revenue policies should treat people of equal means similarly. This principle should be applied for each revenue source. The overall tax structure should also minimize regressivity. Overall tax payments as a proportion of income should not be higher for those with lower incomes than for other taxpayers. User fees should be charged for specific services and government should be prohibited from transferring such funds to other programs. We also need to modernize our processes for tax collection to allow the state to keep up with changes in consumer buying habits such as Internet-based sales. We must also reform the Department of Revenue's process of collection and return of revenue.

Past tax cuts have not generated anticipated economic benefits. Future tax cuts should be reversed if they fail to meet the expected return.

The state has shifted more and more financial responsibilities to counties, municipalities and special districts. Tax policy should balance the fairness of this shift against the benefits of local control and should consider allowing local jurisdictions greater flexibility in generating revenue.

Effectiveness

Arizona's current government financing system is ineffective and will not support our current and desired level of expenditures. Despite the mandate against deficits, Arizona fails to actually match expenses to revenues on a year-to-year basis. Instead the state defers necessary spending, pushes expenses down to local government, sweeps funds into the general fund from the many other state government funds, and uses other accounting maneuvers to create the appearance of a balanced budget while maintaining a structural deficit.

Arizona must recognize that the policies we have adopted have created a highly pro-cyclical government financing system which reduces government revenue at the precise time when additional resources are needed: when the economy falters. Arizona's legal impediments to raising additional revenue, particularly the requirement to have a legislative super-majority to increase or reallocate taxes, have exacerbated the inefficiency of the government financing system. For local governments, levy limits, expenditure limits and tax rate caps limit the ability to provide appropriate services at the local level. The failure to appropriately replenish the budget stabilization fund is short-sighted and sacrifices Arizona's opportunity to maintain a safety net to protect against the cyclical nature of our government financing

system. Rather than planning for long-term needs during times of prosperity, Arizona has instead chosen to reduce taxes and spend intermittently to address political demands, creating budget policies that reduce revenue and program predictability and stability.

Moving forward, Arizona needs to implement long-term planning as part of the budget-setting and revenue-generating process. A rolling six-year strategic plan building upon the voter-approved General Plans from each county and municipality looking at both revenue and spending would improve efficiency and result in a budget process that is better planned. As part of the strategic planning process, Arizona should evaluate ways to manage our government financing system to be less reactionary and more in line with the Revenue System Guiding Principles: stability, responsiveness, predictability, efficiency, competitiveness, exportability of tax burden, neutrality, horizontal equity, vertical equity and simplicity. These terms are explained in the 109th Town Hall's background report. This process should be implemented at both the state and local levels. Changes to spending priorities must be considered, including shifts in funding for transportation, infrastructure, education, and criminal justice.

Arizona must also eliminate its structural deficit and look for ways to optimize its government financing system rather than simply addressing system inefficiencies. One strategy to be considered is adopting a two-year budget to offset short-term cyclical deficits. Arizona should also consider whether there are further opportunities for consolidations and budget cuts. In addition, Arizona must investigate ways to modernize the tax system to make it more equitable, transparent, flexible, and reflective of today's economy. A broader tax base, coupled with a more straightforward tax policy, would be a step in the right direction. To facilitate the development of more consistent policies such as the strategies recommended here, it may be worthwhile to consider eliminating or at a minimum extending legislative term limits that tend to remove legislators just as they develop useful institutional knowledge. Lastly, the Arizona legislature should eliminate the practices of fund sweeps and enacting unfunded mandates on local government. However, all of these actions will not substitute for the necessity of the state to enact a substantial increase in revenue.

State and Local Interaction

Arizona's financing system requires that local governments rely on state funding to a significant degree. State shared revenues were designed to promote tax equity and encourage increased local decision-making. This has worked effectively for many years in programs where the state distributes Federal funding such as Area Agencies on Aging and Head Start. However, for other programs this dependency has hampered the ability of localities to provide services to their constituents especially during economic downturns. By stabilizing cyclical state financing systems and broadening the tax base, local governments would be better equipped to consistently provide services.

For state and local government financing systems to work together more efficiently, increased transparency and accountability is needed at the state level. Anticipated revenues should not be swept back to the state from such funds as highway user revenue fund (HURF) and lottery revenue. Formulas used for collecting and distributing taxes, such as highway funding, should be updated to reflect current conditions to ensure there is adequate revenue to meet the specific needs.

Unfunded and underfunded mandates must be eliminated. These mandates require local governments to either let the programs fail or find alternative revenue sources, thus allowing the state legislature to push the burden of often difficult choices on city and county leaders. Sometimes confusion is created as to areas of responsibility between levels of government resulting in inefficient overlap and even competition. When the state does not do its part, it creates inequities such as shifting school maintenance and construction costs to local districts which have limited ability to raise funds through local bonds and overrides. In addition, less affluent districts may not be able to afford these solutions. Legislators need to be more cognizant of the issues facing local leaders and should work collaboratively with them to find mutually beneficial financing options.

When state governments shift funding responsibilities to local governments they should also transfer management and control of the underlying programs. Additionally, local governments should be given more tools to pay for programs including tax increment financing, greater flexibility to levy taxes, and the authority to impose local gas taxes to fund local road maintenance and improvements.

Arizona needs the input of all stakeholders, including the public, to make state and local financing systems work together better. This calls for reaching agreement on common goals, openness, transparency, and improved reporting.

Educational Needs

The foremost example of Arizona's failure to provide for the well-being of its citizens is education funding. Education provides the foundation for the well-being of the state itself and its citizens. A well-functioning education system leads to a better educated citizenry which attracts employers who provide better paying jobs. People who have more opportunities to earn a living wage are at reduced risk for committing crimes and may require fewer social services. They also generate more revenue for the state through higher wages and increased spending. However, Arizona has not accepted its responsibility for providing an adequately funded educational system.

Providing for "well-being" in terms of education means providing for the diversity of our students, maintaining and building schools, providing adequate teacher salaries and helping to prepare our students to succeed in the world. However, education in Arizona is characterized by disparity. We have amazingly high performing schools, including both district and charter schools, that score at the very top in national comparisons. But we also have distressingly low performing schools (particularly in poorer areas) and too many students entering Arizona's community colleges and universities require remedial education on subjects they should have learned in high school. This simply exacerbates the funding shortage by doubling the cost to educate students on these subjects. Arizona has further aggravated the education funding problem by enacting tax credits and creating the Empowerment Scholarships Account program, both of which facilitate moving students from public to private schools and directly reduce income tax revenue to the state.

Arizona spends less on Pre-K-12 education than nearly every other state in the nation and the legislature has used education funding as a veritable piggy bank that it raids to fund other services and programs. At least partly due to funding shortages, Arizona ranks in the bottom half of states for student

performance on standardized tests, such as the SAT and ACT.

Another way in which Arizona fails to provide for the well-being of students is through its failure to provide capital improvement funds to schools. Although the state is obligated to fund school maintenance and repairs to ensure equity, those funds have repeatedly been swept by the state legislature to offset budget deficits, resulting in unsafe environments and further burdening districts to rely on bonds to address basic needs.

Arizona's failure to adequately fund post-secondary education defies the Arizona Constitution. Article XI, Section 6 of the Arizona Constitution provides that "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." Instead, as budgets for the state's universities and community colleges have been slashed by the legislature, a substantial portion of the resulting funding gap has been borne by the students themselves. Particularly at community colleges, funding has been severely cut. Between 2008 and 2015, tuition increases in Arizona were among the highest in the country. This situation jeopardizes the state's ability to reach its goal of having at least 60% of Arizonans complete some degree of post-secondary education, such as a certificate or level, by 2030.

To correct these deficiencies, Arizona must alter its education financing system to dramatically increase funding so the state can provide the level and quality of education that Arizona's citizens want and need. As a first step, Arizona should establish a benchmark for adequate education funding so we know the funding levels that must be provided. As part of this process, Arizona should review its funding formula for Pre-K-12 educational needs, which has not been updated in nearly 30 years. Specifically, to give every child access to a quality education, the funding formula should be modified to give additional funding to school districts based on the population of students who qualify for free or reduced cost school lunch and the population of special needs students. In addition, Arizona should expand funding for early childhood development, which encourages children to become successful learners and substantially reduces the likelihood of a child later engaging in crime. Arizona should also provide funding to evaluate behavioral health issues for early intervention. Arizona also needs to address education in the arts. Arizona should reinstate funding for freshman year Joint Technical Education Districts (JTED) programs, as well as secure permanent funding for long-term JTED sustainability at all levels.

For post-secondary education, Arizona should restore the more than half a billion dollars that were cut from the Arizona Board of Regents' budget over the last nine years and ensure adequate funding to cover at least half the cost of in-state tuition for post-secondary education. Lastly, Arizona should continue to expand higher education entrepreneurial programs that generate revenue for higher education.

To generate the revenue needed to meet these demands, Arizona should reauthorize and increase the temporary sales tax increase that was approved by voters in 2000 as Proposition 301.

Arizona should strengthen accountability from the funding recipients based on measurable performance metrics. Arizona should also look for ways to optimize the cost of providing education. Arizona should consider refinements, limits or even the elimination of tax credits and empowerment scholarship accounts for private school tuition, and should assess the impact of these credits on the overall quality of education provided to all Arizona children. If tax credits are to be retained, their availability

should be limited based on financial need. In addition, opportunities to reduce and optimize costs may exist with respect to administrative costs, including combining multiple school districts with voter approval.

Financing Infrastructure

Arizona's government financing system does not adequately fund current or future transportation infrastructure needs. The roads are deficient in many parts of Arizona and public transit is inadequately funded. Moving into the future, revenue projections show that Arizona will not be able to maintain existing roads, leaving them to deteriorate further. Road expansion will likely be infeasible. The W.P. Carey School of Business at Arizona State University estimates the amount of money necessary to build adequate transportation infrastructure in Arizona in the next 25 years between \$253 billion and \$311 billion.

This problem arises because Arizona's transportation infrastructure financing system, which relies heavily on the standard gas tax, has not been updated to reflect modern driving habits, technology and vehicle fuel economy, nor has the gas tax been raised over time to meet inflation and increased construction costs. In addition, the state legislature has swept funds from HURF to balance the state budget. These sweeps reduced the funds that otherwise would have been distributed to cities, towns and counties, thus impeding their ability to complete road maintenance.

Other infrastructure needs are likewise unmet by Arizona's government financing system and present issues of inequitable opportunity and access to vital services in some parts of the state. Broadband infrastructure varies across the state and there is no stable source of revenue to broaden its distribution. Utility infrastructure, including water and sewer infrastructure, is also a concern for the future. These needs should be considered by the Arizona legislature, which should develop a strategic plan that evaluates all of Arizona's long-term infrastructure needs and a plan to finance those needs.

Changes to the government financing systems for infrastructure must be considered to facilitate economic development and to meet Arizona's obligation to provide safe highways, adequate utility systems and access to effective communications systems. All potential sources of funding should be considered with the goal of diversifying the current revenue stream. Such sources include increasing and indexing the gas tax; implementing public private partnerships; utilizing flexible gap financing; constructing toll roads; increasing vehicle registration fees; indexing and increasing taxes on rental cars, tires, fluid changes and other vehicle services; implementing a mileage tax; improving existing infrastructure financing methods such as community facilities districts; and tax increment financing.

Additional changes that may be needed to promote the long-term, consistent view that will be necessary to fund Arizona's infrastructure needs include increasing the terms for legislators, repealing the requirement for a super-majority to raise revenue, and preventing the legislature from using funds designated for infrastructure to fund other purposes.

Supporting Arizona's Natural Resources

Arizona must provide strong stewardship of its natural resources to meet water resource requirements, ensure healthy forests, protect wildlife, and promote tourism and recreation.

The state legislature must adequately fund the Arizona Department of Water Resources (ADWR) to oversee our water conservation efforts and vigilantly protect against encroachment by neighboring states as Colorado River water is over-allocated and deficits loom. ADWR is understaffed and lacks sufficient personnel to carry out its mission.

The budget for Arizona's Parks Board has seen dramatic cuts and current funding does not provide for the preservation of our many parks and trails. We must also expand our planning and budget horizons so that agencies responsible for supporting natural resources can make necessary longer term investments. Pima County's Sonoran Desert Conservation Plan is an example of this kind of long-term planning.

Arizona must work closely with the Federal government to protect our forests from catastrophic wildfires on both state and Federal land. We also need to encourage innovative methods of forest management including commercial biomass to provide for forest health and provide new income sources for rural Arizona.

Arizona's government financing system does not adequately allocate funding which negatively affects the well-being of Arizonans. While education, health care, criminal justice and other social programs are evaluated by the legislature as separate and distinct budget line items, these programs are, in fact, highly interrelated. To provide coordinated community services, Arizona should evaluate and fully fund them as an integrated system. Arizona must also adopt an approach that appropriately considers the on-going needs of these programs rather than focusing on them only when they reach a "crisis" level. To achieve this, the legislature needs to focus on outcomes and support spending that results in the overall well-being of the state's citizens.

Health Care Needs

In general, Arizona does provide for its citizens' well-being through an adequately funded health care system. Although Arizona's Medicaid program, the Arizona Health Care Cost Containment System (AHCCCS), needs to be updated to address more current conceptions of wellness care, including nutrition and other lifestyle management, AHCCCS is adequately funded. In fact, AHCCCS provides substantially more funding to hospitals than do health care systems in other states. Assuming federal funding remains constant regardless of any changes to the Federal health care structure, AHCCCS should remain adequately funded. Nevertheless, it is critical that Arizona maximize participation in any Medicaid expansion and take full advantage of any other Federal support for state health care systems. Arizona should also take advantage of the Federal 1115 waiver program. In addition, potential improvements to the medical oversight program could also be realized, including the consolidation of multiple regulatory boards.

Arizona does not, however, adequately provide for its citizens' mental health care needs. Mental health services are not adequately accessible, particularly to preventative care and residential mental health facilities. In some ways, the Arizona Department of Corrections and our jails have become the de facto mental health care providers for the state. Instead, Arizona should provide additional funding for mental health care for people outside of incarceration, resulting in a substantial reduction in cost to taxpayers. Arizona would better promote well-being by providing comprehensive attention to both mental health treatment and prevention before it is court ordered.

Another area where Arizona could improve the well-being of its citizens is through veterans' services. Although this area is truly a Federal responsibility, Arizona should step in when the Federal system fails our veterans. Arizona should work collaboratively with the Federal government to fund these needs.

Criminal Justice Needs

Arizona should fund an independent study on the cost-effectiveness and benefits of privatized prisons versus publicly-run prisons. The study should consider the societal costs and benefits of differing forms of incarceration.

Arizona's allocation of funds for criminal justice is adequate overall but the funds are not properly allocated. While the Arizona Department of Corrections is well funded, Arizonans would be much better served through programs that provide intervention before incarceration is required. Funding prisons is a crisis management approach to criminal justice that ultimately costs more than would be spent on early intervention, such as substance abuse treatment and mental health care. Maricopa and Pima Counties have recently launched substance abuse programs and counties in Arizona have implemented successful Drug Court programs, but larger programs are needed and they need to expand across the state.

Arizona also spends disproportionate funds on the Arizona Department of Juvenile Corrections. Funding for juvenile justice has remained static over time even while the number of youths in the system has fallen. The state budgets \$40 million to administer juvenile corrections including \$12 million paid by the counties. This expense seems disproportionate to the number of juveniles who are incarcerated and on parole (186 and 213, respectively, as of March 31, 2016). By investing in programs to keep at-risk youths out of the juvenile justice system, cost savings could be realized. However, funding for these types of programs have been cut in recent years.

Arizona should also consider reviewing mandatory sentencing requirements (particularly for non-violent offenses), including minimum sentencing and requirements to serve at least a minimum percentage of a sentence. These changes could substantially reduce the cost of the criminal justice system. Arizona should also implement and consistently fund cost effective alternatives to confinement for non-violent criminals, including prevention and diversion programs. Moreover, Arizona should invest in offender rehabilitation and improvement programs and job training to reduce recidivism rates.

Other Human Services Programs

Aside from education, health care and criminal justice, Arizona needs to invest in other social programs, including housing and family services for underserved populations to provide for the well-being of all its citizens. For instance, adequate funding should be provided for Department of Child Safety programs to help keep families together as well as programs to help care for Arizona's aging population, particularly veterans. Arizona should also reinstitute state subsidies for daycare for working parents and look for opportunities for public private partnerships and pay-for-success bonds to provide programs for children and the elderly. Additional funding is also needed for Temporary Assistance for Needy Families.

Impact of the National Economy

Federal budgeting and programs have a major impact on Arizona's economy largely due to military bases, Federal contracts, and substantial Federal lands and programs. When Federal funding is reduced, state funding may be needed to offset negative impacts on schools, social services and infrastructure. The impact of this could be seen when spending cuts at Fort Huachuca had a significantly adverse effect on the local economy in southern Arizona.

Arizona's economy also benefits significantly from trade with Mexico and we need to encourage the Federal government to improve the infrastructure supporting that trade, fund efforts like 4FrontED, and take further steps to facilitate and expand port of entry crossings.

Supporting Business Development

State and local government need more economic development tools to respond faster and more effectively to changing economic conditions enabling them to attract more diverse, private sector, high-wage-paying employers. These tools include reenacting tax increment financing and implementing an Economic Development Reimbursement Authority to fund local infrastructure.

Many of Arizona's jobs are created by small businesses and the complexities of the business tax structure, including the sales tax, chill business launches, growth and hiring.

Because of the volatility of Arizona's cyclical economy, we need to broaden the tax base, reduce the dependency on sales tax, and better fund the budget stabilization fund in times of surplus to ensure stability during economic downturns. Ironically, Arizona's comparatively low property tax has, in part, led to growth and development that has promoted these cycles. We need to diversify our economy to help moderate the impact of these cycles. For example, communities in the Verde Valley have come together to create and coordinate a business diversification plan. State and local communities should consider following Verde Valley's example. We need to encourage and support non-cyclical business such as our growing medical and biotechnology sectors.

Time to Reconsider Tax Cuts

There has been a prevailing belief in Arizona that reducing taxes will stimulate the economy. After roughly 20 years of tax cuts, there is little evidence to support this view. In fact, Arizonans paid 30% less in general-fund taxes in 2015 than they did in 1992, according to the analysis by economists Dennis Hoffman and Tom Rex. Tax cuts over that period will cost the state's fiscal 2016 general fund \$4 billion in revenue, according to an analysis by economists with Arizona State University's W.P. Carey School of Business.

Further, recent polling indicates Arizona has reached a point where most voters and taxpayers are no longer pushing for tax cuts. In a November 2015 poll from Arizona State University's Morrison Institute for Public Policy and the Walter Cronkite School of Journalism and Mass Communication, 66% of individuals questioned indicated they would be willing to pay higher taxes to improve the state's education system. We need to encourage Arizona's legislators to have the courage to make a greater investment in our state through targeted tax increases. We have repeatedly seen the electorate's willingness to vote for increased taxes when the specific use of the funds is stated unequivocally and the value has been clearly communicated.

The primary issues in attracting and retaining businesses in Arizona are our ability to supply a skilled workforce, good roads, broadband, and public transportation. All of these issues would be helped by a financing system that allows for greater public investment.

We also need to reduce unproductive sales tax exemptions and ensure collection of taxes on Internet-based sales. Auditors and collectors positions, which were eliminated by the Arizona Department of Revenue in 2016, should be restored. These positions annually collect between \$1 million and \$2 million each, according to the department's annual reports.

Removing Barriers

Barriers to improving Arizona's financing system can be removed in several different ways. They have been grouped into budget policy, budget process, informed electorate, and legislative terms recommendations.

Budget Policy Recommendations

We should consider expanding local control by reviewing state-imposed caps on counties, cities, and special districts including the half cent limitation on county increases to sales tax for their general fund and allowing counties and special districts to tax on the primary property valuation rate. This review should include reconsidering the use of the 1979-1980 formula for determining how much they can increase their expenditures each year. The state legislature should also remove statutory barriers that restrict local governments from implementing economic development tools such as tax increment financing.

We should enact a citizen initiative to repeal Proposition 108's 2/3 majority requirement for raising taxation and instead require only a simple majority. We should enact a citizen initiative to

automatically sunset voter protection of future citizen initiatives after ten years if they require additional funding or restrict raising revenues. We should also enact a citizen initiative to require a rolling six-year strategic plan and a two-year budget cycle to encourage longer term thinking.

Budget Process Recommendations

Budgets should not be enacted by the state legislature until the amount of annual income collected is known, which generally happens by the end of April.

We should consider best practices from other states to ensure that the budget stabilization fund is properly structured and implemented to address the cyclical aspects of Arizona's financing structure.

Tax credits should be closely scrutinized to ensure they do not extend beyond the level needed to attract investment and they should be appropriately sunseted. Tax credits should also have a revenue offset to be considered.

We should re-establish the Joint Legislative Committee on Tax Policy to promote objectivity and mitigate partisan proclivities. We should foster trust in the budget process by ensuring openness and transparency.

Informed Electorate Recommendation

We must educate Arizonans on the importance and benefits of government and making investments in the public sector, such as quality education and infrastructure. It is critical that we all understand these investments are not only the right things to do but also that they directly benefit each of us just as the failure to make these investments negatively impacts us. We should encourage supportive civic leadership from business, professional, and community leaders.

Legislative Terms Recommendations

Existing term limits make it difficult to retain institutional knowledge and do not foster long-term thinking. They should be eliminated or alternatively, the term lengths in the House should be increased from 2 to 4 years and those in the State Senate should be increased from 2 to 6 years. Terms should also be staggered for even and odd numbered districts.

Setting Priorities and Taking Action

Financing Arizona's future requires bold leadership, a long-term strategic plan, vision, and commitment. It requires that the state legislature give counties, cities, and special districts the tools and authority to raise the funds they need and to manage the programs they decide provide the best results for their residents. It calls on us to educate Arizonans and our public officials on the importance and benefits of using taxes to make investments in quality education, health and infrastructure. And it demands that our budget process be transparent and go beyond partisan differences to truly act in the best interests of all

our current and future citizens.

Arizona should solicit input from business and community leaders from across the state to identify specific measurable outcomes we can anticipate from public investment of tax dollars, work with stakeholders throughout Arizona to help increase awareness of the importance of those investments, and encourage legislators to lead us in seeking the revenue we need to grow our state. The coalition of business and community leaders should be prepared to take the lead in advancing this agenda if the legislative or executive branches do not do so, such as by initiative proposals and publicity campaigns.

Arizona needs to take the following actions to improve its government financing and the entities listed below in the parenthesis should lead the effort.

- Broaden our tax base to provide more stable and predictable revenue including ensuring collection of sales and use tax from Internet-based sales. Along the same lines, we need to ensure that the budget stabilization fund is properly structured, funded and implemented to address the cyclical aspects of Arizona's financing structure. Simplify the tax code in support of small business understanding and filing. (Legislature, Governor, ballot initiative)
- Consider long-term solutions for financing education including renewing and increasing Proposition 301. (Legislature, Governor, ballot initiative)
- Restore a viable level of funding to achieve specific measurable outcomes for education, including pre-K-12, community colleges, vocational programs, JTEDs, and universities, even if taxes need to be increased. Restore the more than half billion dollars that were cut from the Arizona Board of Regents' budget over the last nine years. Consider limiting and even eliminating private school tax credits and empowerment scholarship accounts. (Legislature, Governor)
- Enact a citizen initiative to repeal Proposition 108's 2/3 majority requirement for raising taxation and instead require only a simple majority. (Ballot initiative)
- Take steps to make the budget process more open and transparent to our citizens by including multiple opportunities for stakeholder input during the process; develop a shared vision for Arizona; move from annual to biennial budgeting; and require a rolling six-year strategic plan. Consider planning initiatives such as Envision Utah and Healthy Colorado as best practice models and require that programs meet measurable objectives. (Legislature, Governor, ballot initiative)

- Balance the state’s revenue sources to ensure both vertical and horizontal equity in light of the growth of the service economy, the regressive nature of the sales tax, and the small contribution of property taxes to total revenue. (Legislature, Governor)
- Encourage and support the growth and diversification of Arizona’s economy by authorizing local governments to use the economic development tools they need, including tax increment financing, community facility districts, and both public-private partnerships and an Economic Development Reimbursement Authority to fund infrastructure. (Legislature, Governor)
- Prioritize infrastructure investment with a particular focus on expanding access to water, energy and telecommunications in order to meet the current and future needs of all Arizonans and to spur economic development. (Legislature, Governor)
- Update highway user revenue funding and fees to reflect current conditions including higher mileage vehicles; increase and index the gas tax; tax non-gas-using vehicles based on their annual mileage change; allow localities to add local gas taxes; and prevent sweeps of these funds to ensure that our roads and highways are maintained. (Legislature, Governor)
- Eliminate unfunded mandates, to include those to counties, cities, schools and other special districts. If the program is important enough to be run, it is important enough to be funded. (Legislature, Governor)
- Prohibit the state from shifting costs and responsibilities to counties, cities, and special districts. Prohibit the state from taking revenues from counties, cities, schools and special districts. (Legislature, Governor)
- Increase funding for: (1) the Arizona State Land Department to allow for more effective management and disposition of State Trust Land; (2) the Arizona Department of Water Resources to oversee Arizona’s water preservation efforts and to protect Arizona’s water resources; and (3) the Department of Revenue to restore auditors in order to assure that uniform collection of taxes are enforced, thereby enhancing revenue. (Legislature, Governor)
- Facilitate long-range planning by increasing legislative terms and eliminating term limits. (Legislature, Governor)

- Enact a citizen initiative to automatically sunset voter protection of future citizen initiatives after ten years if they require additional funding or restrict raising revenues. (Legislature, Governor)
- Require an independent audit of the adult and juvenile justice systems that reveal the current costs of incarceration. Compare the private versus the public expenses and make recommendations for changes to increase efficiency and safety based on best practices experienced throughout the country. Consider reforms to the criminal justice system intended to reduce recidivism while also reducing costs, including adult and juvenile diversion programs; using early release; and eliminating mandatory sentencing and requirements that inmates serve a minimum percentage of their sentences. (Legislature, Governor)
- Encourage veterans and military personnel to move to and remain in Arizona by enacting legislation similar to the Hazlewood Act in Texas that provides qualified veterans, spouses, and dependent children with an education benefit of up to 150 hours of tuition exemption, including most fee charges, at public institutions of higher education in the state, excluding living expenses, books, and supply fees. (Legislature, Governor)
- Restore health-care funding to meet statutory requirements. Focus on upstream solutions such as preventative care. (Legislature, Governor)

Addressing the issues facing Arizona's government financing system is imperative to the state's continued prosperity. It will not be enough to simply reduce expenditure: Arizona also must increase revenue and reconsider the allocation of existing resources. Educational and infrastructure funding are woefully inadequate, and the allocation of resources for health care and criminal justice services is sub-optimal. The recommendations in this report of the 109th Arizona Town Hall offer workable solutions to achieve the appropriate balance.