



Fiscal Alternative Choices Team (FACT)

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FISCAL ALTERNATIVE CHOICES TEAM (FACT) REPORT

Members:

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Background

- Senate President Robert “Bob” Burns asked university Presidents on January 26th to examine options for closing Arizona’s widening budget deficit.
- A 10 member team from the universities and ABOR developed the FACT report in about 7 weeks.
- Report contains options and is not a set of recommendations.



Background

continued

- We are in the midst of the worst economy and state budget conditions of modern times.
- The housing, financial, equity and commodity markets have all collapsed.
- January 2009 General Fund collections were 36 percent less than 2 years ago.
- The baseline budget deficit is forecast at \$3.6 billion in FY 2010.
- Arizona's budget deficit, on a percentage basis, is ranked either #1 or #2 nationally.



CONCLUSIONS

- Balancing the budget entirely through budget cuts is not feasible; a more balanced approach is required
- No “good” options exist for eliminating a deficit of this magnitude
- The economic recovery will be very gradual, with revenues not expected to rebound significantly until after FY 2012
- In the longer term, either the tax structure must be made less subject to the economic cycle and/or the size of the Budget Stabilization Fund must be dramatically increased



SHORT-TERM BUDGET BALANCING

Federal stimulus monies

Spending reductions

Revenue enhancement



Short-Term Budget Balancing Options

1. The Governor Should Optimize the use of Federal Stimulus Monies from the ARRA to Reduce Projected Deficits.
2. Enact or Seek Voter Approval of Temporary Tax Increases.
3. Seek Voter Approval for Relief from Certain Voter-Protected Spending Requirements Under Strict Criteria.



Short-Term Budget Balancing Options continued

4. Sales Tax Increase and Reform – Broaden the Base of the Tax and Lower Rates.
5. Income Tax Increase and Simplification— Movement toward a “Flat Tax”.
6. Delay Elimination of the State Equalization Tax (state imposed school property tax) until after FY 2012.

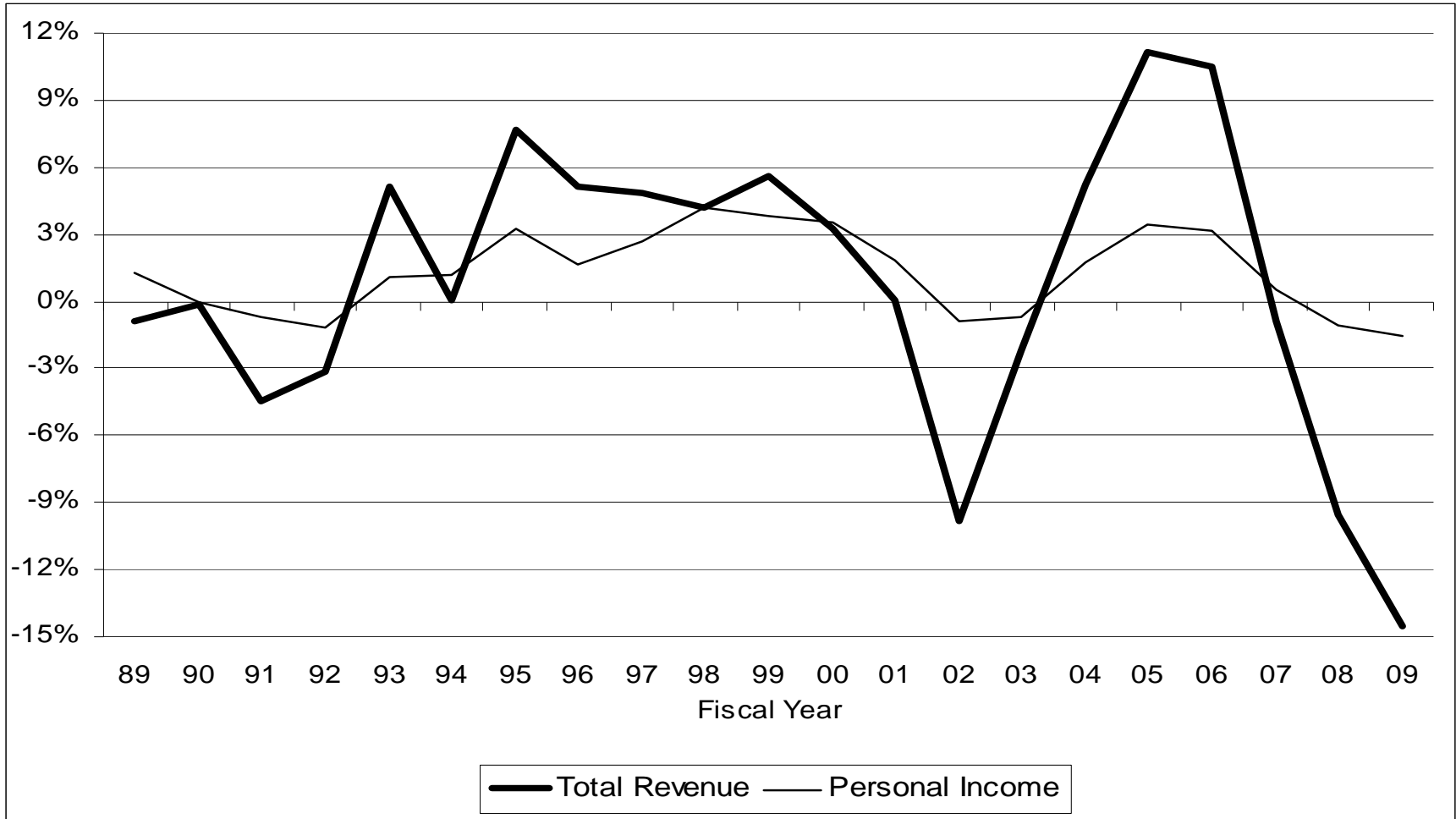


Short-Term Budget Balancing Options continued

8. Retain a Significant Portion of the Vehicle License Tax (VLT) Revenues in the General Fund as was once done.
9. Sale-Leaseback Programs Can Provide a Short-Term Revenue Boost.
10. Additional “Rollover” Opportunities Exist, but Must be Measured Against Cash-Flows—these were used to balance FY09.
11. Resist Cutting Positions in Revenue-Producing Agencies such as ADOR and State Land.

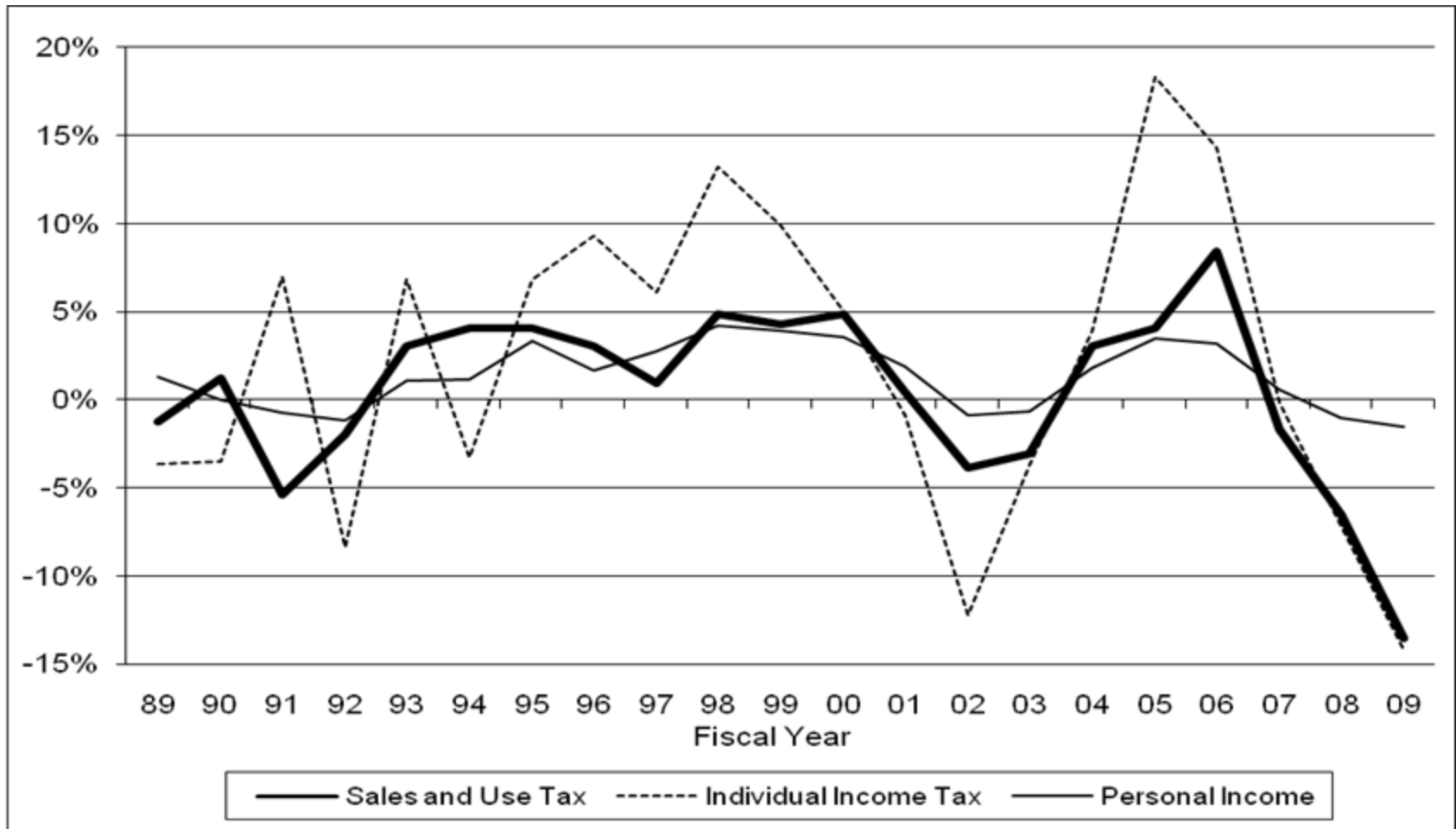


ANNUAL PCT CHANGE IN REAL PER CAPITA DOLLARS: GENERAL FUND REVENUE AND PERSONAL INCOME





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



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



Long-Term Budget Balancing Options

1. Create a More “Defensive” State Tax Structure.
2. Modify, Expand and Strengthen the State’s Budget Stabilization Fund.
3. Match Tax Cuts with Spending Cuts and Spending Increases with Tax Increases on a “Business Cycle Neutral Basis”.



Long-Term Budget Balancing Options

Continued

4. Create a Dedicated Funding Stream for Students FIRST and Rely on Debt Financing when State Finances are Constrained by Recession.
5. Further Privatization of State/Local Services.



TEMPORARY TAX INCREASE

- A possible schedule of the change in revenue (all years relative to current revenue) is
 - FY 2010 plus \$1,000 million
 - FY 2011 plus \$1,000 million
 - FY 2012 plus \$750 million
 - FY 2013 plus \$250 million
 - FY 2014 and thereafter minus \$200 million
- The additional revenue could result from an increase in sales tax or personal income tax rates



TEMPORARY SALES TAX INCREASE

- To achieve these revenue flows, the sales tax rate would increase from 5 percent to
 - 6.25 percent in 2010 and 2011
 - 5.85 percent in 2012
 - 5.25 percent in 2013
- This assumes an increase in sales tax revenue is shared with Arizona's county and municipal governments
- To offset the short-term increases in rate, the tax rate could be permanently set at 4.8 percent, which would result in revenue in 2014 that is \$200 million less than if the rate were the current 5 percent
 - The breakeven point would be 2026
 - By 2040, cumulative revenue would be \$4.7 billion less



TEMPORARY PERSONAL INCOME TAX INCREASE

- The tax rate would increase
 - 31 percent in 2010 and 2011 (from bracket rates of 2.59, 2.88, 3.36, 4.24 and 4.54% to 3.39, 3.77, 4.40, 5.55 and 5.95%)
 - 23 percent in 2012
 - 7 percent in 2013
- A rate reduction of 6.25 percent from existing rates would reduce the revenue in 2014 by approximately \$200 million
 - The breakeven point would be 2026
 - By 2040, cumulative revenue would be almost \$5 billion less



EXPAND SALES TAX BASE

- The sales tax base might be expanded to include:
 - Personal services, educational services, auto repair
 - Wages and salaries for labor employed in construction
 - Food to be consumed at home
 - Commercial leases
- Regressivity could be lessened by using low-income tax credits
- With no change in tax rate, these revenue sources would raise general fund revenue by \$1.6 billion (assuming revenue sharing)
- Without increasing revenue, the tax rate could drop from 5 to 3.7 percent



SIMPLIFY THE PERSONAL INCOME TAX

- Tax simplification means basing the state tax due strictly on federal adjusted gross income
 - Deductions, additions and subtractions to income would be eliminated
 - A standard exemption for the taxpayer(s) and dependents would remain
- A **flat tax** rate will shift the tax burden from very high income earners to others
 - The size of the shift can be reduced by increasing the amount of the standard exemption
 - The lowest incomes can be held harmless



SIMPLIFY THE INCOME TAX

- A **graduated tax** rate can avoid this shift in tax burden
 - The tax burden could be reduced at lower incomes and held constant at higher incomes while still raising as much revenue – by increasing the number of taxpayers
- The tradeoff between a flat tax and graduated tax is largely one of competitiveness versus vertical equity
 - A flat tax also will result in a modest improvement in stability and predictability



BUDGET STABILIZATION FUND

1. Increase the cap of the BSF to at least 15 percent
2. Change the funding formula so that substantially more monies are transferred to the BSF during periods of strong economic growth
3. Either tighten the statutory language or place the operation of the BSF into the Constitution
4. Create another contingency fund to deal with unexpected funding needs
5. Either create a third contingency fund to deal with cyclical expenditure needs in health and welfare or expand the size and role of the BSF
6. Eliminate the existing structural deficit
7. Do not create a new structural deficit: do not increase spending without increasing revenue and do not reduce taxes without reducing spending



FACT AND CFRC

- Considerable correspondence exists between the FACT options and the recommendations of the 2003 Citizens Finance Review Commission
- Nearly all of the CFRC's work remains relevant today



RESPONSE TO BURNS LETTER: PRIVATE AND PUBLIC SECTORS

- A direct comparison between the private and public sectors is often misleading
- Most of the private sector is negatively affected during an economic recession because demand for their goods and services significantly declines
- The public sector is unlike most of the private sector: demand for most government services does not decrease during a recession and many public services experience a countercyclical increase in demand



RESPONSE TO BURNS LETTER: TAX INCREASES & SPENDING CUTS

- Government employment is not currently falling as much as private-sector employment
 - However, between 1995 and 2007, state government employment rose only 8 percent while private-sector employment increased 60 percent
- During a recession, both tax increases and government spending reductions have a negative economic impact
- The negative economic effects are more severe by reducing government spending than by raising public-sector revenue



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

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



RESPONSE TO BURNS LETTER: TAX INCREASES

- A temporary increase in the sales tax of 1.25 cents would increase state general fund revenue by about \$1 billion per year
 - This assumes that revenue sharing with counties and municipalities continues
 - The use of low-income tax credits could minimize the negative effects on low-income households
- A tax increase of this magnitude would be approximately \$150 per year per Arizona resident, or about \$400 per year for the average-sized household
 - This is a considerably lesser amount than the federal tax rebate of 2008 and the federal tax reductions in 2009 and in 2010
 - Using the Tax Foundation's tax burden data, Arizona still would be a low-tax state after implementing such a tax increase, ranking 37th (the current rank is 41st)

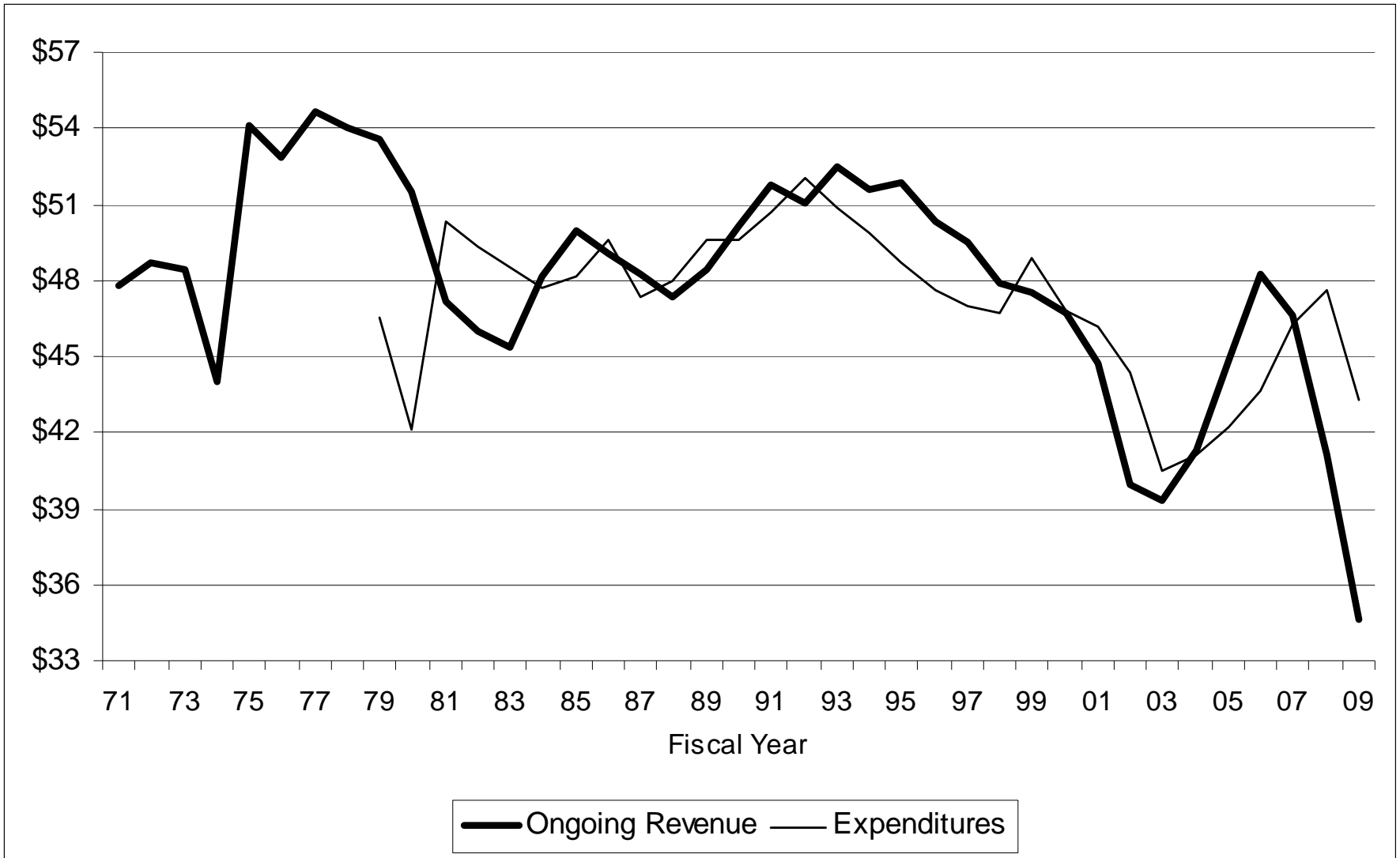


RESPONSE TO BURNS LETTER: STATE GOVERNMENT

- Arizona state government has shrunk over time relative to the size of the economy, with spending at the peak in fiscal year 2008 still less than in most earlier years
- Over the 31-year time period of spending data, the 2009 spending figure is fifth lowest overall, and the lowest for education



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





Questions and Discussion

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