

1-2011

## Structurally unbalanced: Cyclical and structural deficits in Arizona

Matthew Murray

Kristin Borns

Susan Clark-Johnson

Arizona State University, susan.clarkjohnson@asu.edu

Mark Muro

Brookings Institution, mmuro@brookings.edu

Jennifer Vey

*See next page for additional authors*

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### Repository Citation

Murray, M., Borns, K., Clark-Johnson, S., Muro, M., Vey, J., Brookings Mountain West, Morrison Institute for Public Policy (2011). Structurally unbalanced: Cyclical and structural deficits in Arizona.

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**Authors**

Matthew Murray, Kristin Borns, Susan Clark-Johnson, Mark Muro, Jennifer Vey, Brookings Mountain West, and Morrison Institute for Public Policy

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## Structurally Unbalanced: Cyclical and Structural Deficits in Arizona

By Matthew Murray with Kristin Borns, Sue Clark-Johnson, Mark Muro, and Jennifer Vey

*Though the Great Recession may be officially over, all is not well in Arizona.*

*Three years after the collapse of a massive real estate “bubble,” the deepest economic downturn in memory exposed and exacerbated one of the nation’s most profound state fiscal crises, with disturbing implications for Arizona citizens and the state’s long-term economic health.*

*This brief takes a careful look at the Grand Canyon State’s fiscal situation, examining both Arizona’s serious cyclical budget shortfall—the one resulting from a temporary collapse of revenue due to the recession—as well as the chronic, longer-term, and massive structural imbalances that have developed largely due to policy choices made in better times. This primer employs a unique methodology to estimate the size of the state’s structural deficit and then explores the mix of forces, including the large permanent tax reductions, that created them. It also highlights some of the dramatic impacts these fiscal challenges are having on service-delivery as well as on local governments. The brief suggests some of the steps state policymakers must take to close their budget gaps over the short and longer term. First, it urges better policymaking, and prods leaders to broaden, balance, and diversify the state’s revenue base while looking to assure a long-haul balance of taxing and spending. And second, it recommends that Arizona improve the information-sharing and budgeting processes through which fiscal problems are understood—so they may ultimately be averted.*

### I. Introduction

Technically, the Great Recession has ended. Economic output is growing and modest signs of labor and housing market stabilization are evident. Yet many Arizona citizens would be hard-pressed to express a belief of brighter days and more economic opportunity ahead. Three years after the collapse of a massive real estate “bubble,” the deepest economic downturn in memory has exposed a statewide moment of reckoning—Arizona’s fiscal crisis looms large, with little to no sign of abating.

Complicating the moment is the fact that the state’s dire budget crisis is really two-fold, because at present Arizona suffers not only from a massive cyclical deficit but also a gargantuan structural deficit.

*Cyclical* deficits can spike in economic downturns when reduced economic activity diminishes revenue performance while lower incomes and higher unemployment rates put added pressures on spending. At the same time, though, a weak economy can also help expose longer-term *structural* (or chronic) imbalances between revenues and expenditures. In this circumstance revenues consistently fail to grow in tandem with expenditure obligations and the cost of government, often because past policy actions have thrown off the balance of incoming revenue and ongoing spending.

In this fashion, Arizona is now struggling with two related but distinct fiscal disasters. Recognized is the portion of the state's budget crisis that has resulted from the sudden collapse of annual revenues after the real estate crash and economic downturn. This crisis has hit hard but will ease as the economy recovers.

Less understood is the depth of the state's massive structural imbalance, which has arisen thanks in large part to policy choices made during the go-go years of the state's recent past but which will not soon relent. During the growth years, legislative and executive leaders acted as if the state could maintain a basic level of service provision even as it implemented tax cuts that permanently reduced the state's revenue base.

Now, the illusion has been shattered and the state's yearly labors to close its fiscal year budget gaps are about to get harder. With one-time fixes, gimmicks, and fund sweeps exhausted, budget cuts from this point forward could—if handled crudely—prove devastating and difficult to recover from. Serious discussions among state leaders have included opting out of Medicaid, cutting a K-12 system often cited before the recession for receiving the lowest per-pupil funding in the nation, and significantly reducing funding for the state's university system. At the same time, if managed well (that is, with a balanced approach and a sense of strategy and rigor) the crisis might actually prompt innovation instead of just pain.

But what is certain, at any rate, is that the current fiscal crisis will continue to have lasting and damaging ramifications unless the state takes prompt, sober steps to address it. To this end, this short introduction to the state's cyclical and structural deficit problems provides two groups of suggestions to the state as it prepares to attack its problems.

First, the state needs to improve the quality of its fiscal policymaking by moving to broaden, balance, and diversify its revenue bases while looking to the long-haul balance of taxing and spending. Implicit in this push must be a recognition that action has to occur on both the revenue and reduction side of the equation. Spending cuts alone are not going to put Arizona on a stable fiscal path.

And second, the state needs to improve the information sharing and budgeting processes through which fiscal problems are identified, analyzed, and addressed. As part of this, the state needs to put in place the sort of strategic plan that furnishes a long-term vision of state success against which budgetary and other sorts of performance can be measured against clear goals and mileposts.

In sum, the choices that need to be made by Arizonans are difficult and will require of leaders substantial self-discipline. Success at this work is imperative as the first order of business for Arizona as the state prepares to embark on its second century.

## **II. Framing the Issue: The Nature of State Structural Deficits**

How can sizable structural deficits or even unmanageably large cyclical deficits exist when states generally are required to maintain budget balance?

There are two basic ways. Cyclical deficits can spike in economic downturns when reduced economic activity diminishes revenue performance and lower incomes and higher unemployment rates put added pressures on spending. At the same time, a weak economy

can also help expose longer-term structural (or chronic) imbalances between revenues and expenditures. Such imbalances arise when revenue consistently fails to grow in tandem with expenditure obligations and the cost of government, or when policy actions throw incoming revenues and ongoing spending out of balance. At any point in time a state's total deficit (surplus) is the sum of its cyclical and structural deficits (surpluses).

What are the factors that influence the emergence of such imbalances? A permanent imbalance between revenues and expenditures may arise from any number of sources that broadly can be placed in three categories: the prevailing fiscal structure, economic and demographic trends, and political decisionmaking. These three factors interact to influence both near-term and long-term fiscal health. Consider each in turn:

- **Fiscal structure.** A state's existing fiscal structure defines expenditure obligations and the means of financing them through the tax system, and will influence the degree of growth in revenues and expenditures over time. This fiscal structure will have its roots in both statute and a state's constitution. Some expenditures may be discretionary while others may be mandated by previous choices made by voters and politicians. For example, state constitutions typically require a level of elementary and secondary education spending that is enshrined in the state's legislated schools funding formula. The revenue system structure used to pay for these and other expenditures includes a mix of taxes (e.g. income, sales, property) and fees and their rates and bases, which also vary from state to state. Overall fiscal performance is therefore heavily influenced by a state's overall revenue and expenditure arrangements, which affect the amount of money coming in and going out of state coffers.

- **The economy and demographics.** Trends affecting a state's economy and demographic composition can impact how a given fiscal structure stands up across budget cycles. All states with a sales tax, for example, have seen revenue performance weaken as the overall economy has become more service-oriented, since the traditional sales tax falls primarily on tangible goods. Population shifts, too, can impact a state's fiscal health. The effects of strong population growth, for example, depend on the extent to which new residents pay for themselves: A large increase of lower-income residents places more pressure on both sides of the budget than does a swelling middle- or upper-income populace. An aging population, moreover, can contribute its own pressures by driving up spending on health and human services. As such, a state largely without cyclical or structural deficits today may see them emerge in the future as economic and demographic trends ripple through the budget, even with no changes in policy.

- **Political decisionmaking.** Political decisions can play a huge role in budget dynamics, as changes made to a state's fiscal structure in one budget cycle can and often do have significant effects on its long-term fiscal health. During periods of strong economic growth, for example, states often enjoy cyclical budget surpluses. Decisionmakers often fail, however, to consider that these surges in revenue are temporary. For that reason, state budget surpluses are rarely saved in their entirety, with only a fraction typically committed to rainy day funds. More often, the bulk of such surpluses is given back to taxpayers through permanent tax cuts or used to support permanent spending increases. As a result, a fiscal shortfall typically emerges during a downturn that includes both the cyclical deficit along with any structural deficit arising from the long-term tax/expenditure mismatch created during previous periods of economic expansion. In this way, policy decisions made by state legislatures or directly by the voting public, as well as by federal mandate, can contribute substantially to the emergence of permanent, recurrent budget imbalances. For example, voter initiatives may be introduced that mandate higher spending or that place restrictions on the effective capacity of states to raise revenues—initiatives that, as noted above, can become fiscally unsustainable as the economy progresses through the classic boom-and-bust cycle.

In any event, these three forces each have an independent influence on the budget and also can interact in such a way as to produce or magnify a fiscal crisis. A classic convergence of crisis-spawning events is a growth cycle that produces rising income tax revenues that in turn lead to tax cuts; healthy revenues that convince the public to mandate spending increases; and a growing population that needs to be served by program expansion. The convergence then brings disaster when the economy falls into a recession, exposing the well-intentioned but ultimately faulty decisionmaking that took place during times of better economic and fiscal health.

Though often overlooked, the imbalances created by structural deficits are hugely important because they further complicate resolution of cyclical fiscal problems. Together, the two sorts of deficits can produce devastating consequences for state economies and their residents: Critical services ranging from public safety to education may be subjected to larger cuts. Infrastructure spending may suffer from greater reductions and deferral. And tax rates may need to be raised further than would be the case if the state were only addressing a cyclical shortfall. Meanwhile, fiscal pressures on a state ripple through to counties, cities, and school districts via reduced aid, diminished tax sharing, and increased spending requirements that create additional hardship. These policy outcomes can have lasting economic effects, and lead to future budget dilemmas necessitating additional spending cuts or tax increases. Most notably, the local government layoffs and service cutbacks that frequently result from state deficit traumas and pass-throughs can depress spending, purchasing, and local contracting and place a serious drag on regional economic performance.<sup>1</sup> Which is to say, state-level grappling with cyclical and structural deficits—and its impacts on localities—can become at a time of economic shakiness the equivalent of a massive “anti-stimulus,” as *The Washington Post* blogger Ezra Klein has put it.<sup>2</sup>

### III. Estimating State Budget Deficits

This analysis of Arizona’s state budget deficits extends from FY 2007 through the current fiscal year. The estimates of cyclical and structural deficits presented are built on a unique methodology, a detailed description of which can be found in the appendix to the companion document, *Structurally Unbalanced: Cyclical and Structural Deficits in California and the Intermountain West*.<sup>3</sup> But three caveats regarding the estimates are worth emphasizing here:

First, the analysis does not account for capital expenditures and revenues/expenditures that are not fully accounted for in the annual general fund budget (e.g. pension funds); these other components of the state budget may also have imbalances that will not be captured here.

Second, the measure of expenditure requirements is based on FY 2008, which may or may not reflect the long-term spending needs of the state. In this respect, the analysis assumes stable economic and demographic patterns. That is, there is no accounting for potentially higher (lower) service delivery costs in future years, either due to differences in input costs or the scope of the population benefiting from service delivery. In practice, there are demographic and economic pressures building in Arizona that have the potential to aggravate structural deficits in future years.

Third, the estimates are sensitive to the fiscal structure and the nature of the state’s political decisionmaking. The expenditure policy changes that have transpired since the FY 2008 baseline are assumed to be temporary, since past experience indicates that recent cuts such as these are mostly restored when revenues rebound. If post-2008 spending cuts prove to be permanent then the structural deficit estimates reported here would be diminished. However, future tax cuts or expenditure increases would add to the structural deficit problem confronting the state.

In any event, the analysis is believed to represent a sound and revealing picture of the state’s situation.

## IV. Cyclical and Structural Budget Deficits in Arizona

So, how serious are the state budget deficits facing Arizona?

In two words: exceptionally serious. According to this present analysis of cyclical and structural deficits in the state, at least three disconcerting trends point to the depth and nature of its fiscal crisis:

**Arizona had by far the largest estimated percentage structural deficit among its peers in the region in FY 2011, standing at over \$2.1 billion, or a mammoth 21 percent of stable expenditures.**

**Arizona is under heavy fiscal stress.** This analysis underscores that Arizona is grappling with an extraordinary general fund deficit that was revealed and exacerbated by the recent Great Recession. The state's shortfalls include both a substantial cyclical deficit, as well as a large structural deficit.

In FY 2011, Arizona had a *cyclical deficit* of 12 percent of 2008 baseline expenditures. To put this in perspective, this is on par with California's cyclical deficit, less than in Nevada, and 3 percentage points larger than Colorado's.

Meanwhile, however, the state had by far the largest estimated percentage *structural deficit* among its peers in the region in FY 2011, standing at over \$2.1 billion, or a mammoth 21 percent of stable expenditures. This figure is also far higher than the \$825 million currently reported by the state's joint legislative budget committee as the revenue shortfall for FY 2011 as of November 2010.<sup>4</sup> This \$2.1 billion figure roughly equals total state spending on the university/board of regents system along with all state spending on protection and safety.

Both the cyclical and structural deficit estimates for FYs 2007 through 2011 are presented in Table 1, while Figure 1 shows ongoing revenues and expenditures per \$1,000 of personal income in the state over time.

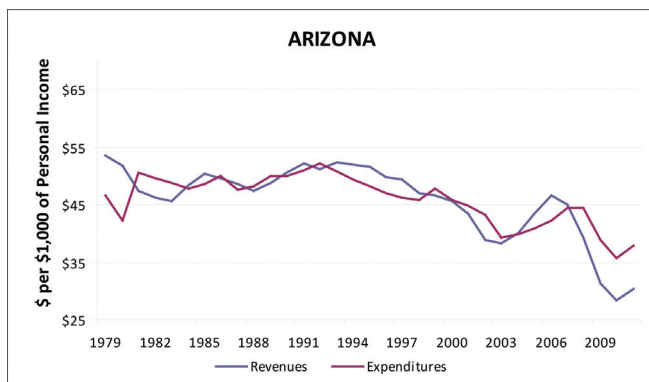
**Table 1. Arizona faces massive cyclical and structural deficits**

Fiscal Year	Surplus or Deficit in Millions			Surplus or Deficit as a Percentage of Stable Expenditures		
	Total	Cyclical	Structural	Total	Cyclical	Structural
2007	\$ -83	\$ 1,669	\$ -1,752	-1%	17%	-18%
2008	-1,381	664	-2,045	-14	7	-20
2009	-3,126	-1,057	-2,070	-31	-11	-21
2010	-3,764	-1,663	-2,101	-38	-17	-21
2011	-3,374	-1,240	-2,134	-33	-12	-21

Source: Brookings Mountain West / Morrison Institute / ASU

**The state experienced a large swing in its cyclical fiscal situation over the past five years while its structural deficit climbed.** In the run up to the recession, Arizona boasted large cyclical surpluses, having benefited from several years of strong economic growth. In fact, at 17 percent of baseline expenditures, the state's FY 2007 cyclical surplus far exceeded that of other states in the region. The state still had a 7 percent cyclical surplus in FY 2008.

**Figure 1. State revenues and expenditures in Arizona have often diverged, creating budget deficits and surpluses.**



- a. For the above chart, the difference between the two lines represents the total deficit or surplus: Where the expenditure line is higher, the difference is the total deficit; where the revenue line is higher, the difference is the total surplus. However, the deficit indicated by a comparison of the two lines is definitionally different than the deficits estimated for this paper.
- b. One-time or temporary budget fixes are not included in the revenue figures.
- c. Expressing the revenues and expenditures per \$1,000 of personal income automatically adjusts for inflation, population growth, and real per capita economic growth.

However, as occurred in other states, Arizona’s fiscal situation took a nosedive the following year, as the economy tanked and revenue yields fell. In FY 2009, the state’s previous-year surplus morphed into a deficit of 11 percent as a share of stable expenditures, before climbing to 17 percent in FY 2010, and then falling to 12 percent in 2011. This dramatic reversal of fortunes owes to the way the state’s particular revenue system interacts with the state’s extremely cyclical economy. The state’s significant swings in revenue over the last two decades, even after adjusting for tax law changes, can be seen in the line chart at left.

Arizona’s structural deficit, meanwhile, was large throughout the period, growing from 18 percent of stable expenditures in FY 2007 to 21 percent in FYs 2009 through 2011. This increase was attributed to continued tax cuts, particularly a large income tax reduction that became effective in 2008.

**Arizona’s structural deficit predates the current recession and is largely the result of policy-induced revenue reductions.**

That Arizona is experiencing a large cyclical deficit is not surprising. So are most states. Though the magnitude of state deficits varies from state to state, the source is largely the same: dramatic drops in revenue due to the recent recession and protracted economic downturn. As the economy slowly

recovers, the cyclical deficit will decline and eventually become a cyclical surplus—but any underlying structural deficits will remain, poised to exacerbate the next economic slump. Structural deficits arise from a more complex set of factors, the relative influence of which varies across states and remains permanent.

Representing longer-term imbalances between revenues and expenditures, structural deficits develop in part from the complex interaction between a state’s fiscal and institutional structures and economic and demographic change.

But states’ fiscal challenges are often compounded by discretionary policy changes and voter initiatives that permanently diminish revenue productivity or increase spending on services. This is clearly the case in Arizona, where its structural deficit is largely, though not exclusively, rooted in policy actions that began eroding the state’s available revenues long before this most recent economic downturn took hold. Beginning in FY 1993, the state implemented tax cuts in every year through FY 2002, and again from FYs 2005 through 2010 (though in only about half of these years was the revenue reduction substantial). Nominally, the net changes during this 17-year period totaled some \$1.7 billion. Adjusting for inflation, population growth, and real per capita economic growth, the cumulative impact climbs to \$2.9 billion. All kinds of taxes were cut, but 58 percent of the total in nominal dollars came from the personal income tax.<sup>5</sup>

On the other side of the budget ledger, two major impacts on general fund expenditures have occurred since the structural deficit began in the early 1990s. First, funding for school construction was shifted into the general fund in FY 1999, with no additional revenue being provided. The annual expense has been as high as \$500 million. Second, in 2000 voters passed two competing ballot initiatives to expand Medicaid by using tobacco settlement monies. However, the specified funding source was inadequate to support the expansions, so additional funding had to be drawn from the general fund. As Figure 1 shows, though, overall general fund expenditures in the state have actually decreased over time.

Meanwhile, Arizona confronts several constraints on fiscal flexibility that are already complicating its ability to eliminate its massive structural deficit. There are two key restrictions that impact Arizona’s budget process. Most notably, the state’s requirement for a supermajority for any revenue increase will greatly hinder revenue-side responses.



**Arizona's deep fiscal imbalances owe mostly to self-inflicted damage to the state's revenue system and related policy changes.**

The most recent example is the temporary one-cent sales tax increase passed by voters in May 2010. The issue had to go to voters, after much debate, because the legislature indicated it could not come close to the number of votes required to pass the revenue measure. As a result, it took more than a year's time from the initial discussion of the revenue increase to passage, time that the state could have been collecting that revenue. While there are those who argue that such a provision may protect the budget process from capricious increases in spending, it greatly complicates prudent fiscal management.

Additionally, Arizona's "voter protection" of programs passed at the ballot box locks in programs unless the issue comes before voters again. As a result, these funds cannot be part of a larger budget solution. By locking these funds away in perpetuity, it makes it difficult to devise prudent responses when the economic climate changes or program needs change.

In sum, Arizona's deep fiscal imbalances owe mostly to self-inflicted damage to the state's revenue system and related policy changes.

## **V. State Impacts, Recent Responses, and Continuing Implications**

Cyclical and structural budget imbalances of the scale roiling Arizona have already had, and will continue to have, disturbing practical consequences.

Most notably, dramatic decreases in spending have already caused significant reductions in service provision across critical program areas. The cuts have been sharp and painful. For example:

- From FY 2008 to 2010 the state sliced K-12 funding by 20 percent, and university budgets by 28 percent.<sup>6</sup> Some of this reduction has been temporarily masked by additional federal stimulus dollars. Those, however, are coming to an end. Likewise, the state eliminated full-day kindergarten earlier this year to free up \$218.3 million.<sup>7</sup>
- The state reduced the lifetime eligibility for Temporary Assistance for Needy Families (TANF) benefits to just 36 months from 60 months—a move that revoked support for 8,200 families.<sup>8</sup>
- And the state recently stopped financing certain organ transplants under Arizona's Health Care Cost Containment System, the state's version of Medicaid.<sup>9</sup>

What is more, Arizona's state budget crisis is also exacerbating local budget distress, as the state has increasingly reduced aid to local governments in order to make up for reduced tax revenue collections.<sup>10</sup> (See the nearby text box.)

## **Impacts: State Aid Cuts Hit Rural and Urban Counties Alike**

Arizona's current 12 percent cyclical deficit and whopping 21 percent structural shortfall are forcing headline-grabbing state government cuts to education and services. Less covered but nearly as disruptive are the grinding, now intensifying impacts of the crisis on the state's rural and urban counties.

Arizona's 15 counties—which manage such critical matters as public safety, health, economic development, and land management—have been working since 2007 to adjust their budgets in response to the economic downturn by laying off personnel, reducing service levels, tapping financial reserves, eliminating non-mandated programs, and decreasing capital projects and road building. But even as county leaders have struggled to get their own fiscal houses in order, the reality of shared state revenue and program responsibility and the need to balance the state budget has piled on an additional load of fiscal burdens. Put simply, the state's budget problems are now dragging these local governments into crisis, with troubling implications for both rural and urban Arizonans.

All told, from FY 2008 to FY 2011, Arizona counties suffered a collective loss of \$193.6 million due to the state's budget woes. Statewide program shifts, where the state pushes the cost of a particular mandated program further downstream onto localities, have cost counties \$44.6 million over these past four budgets. And county receipts of Highway User Revenue Fund monies have fallen by \$40.4 million. County transfers (i.e. the statutorily required transfer of tax dollars from the county to the state general fund) and lost revenue streams from, for example, the elimination of counties' share of lottery revenues, account for the remaining \$108.6 million.

The fiscal impacts of these state-induced revenue drops vary across the state's counties, particularly between its rural and urban jurisdictions. Rural counties, for their part, are hamstrung by a very limited tax base, a result of both their small populations and state legislation passed in the early 2000s that requires hard-to-gain voter approval for any tax hikes. This lack of flexibility leaves these counties' hands tied and unable to react nimbly to volatility in the economy, and the whims of the state. The nearly 40,000 residents of Graham County, for example, have experienced first hand the combined impacts of the state's fiscal laxity—which has translated into a \$1.01 million loss for the county in FY 2011 alone—and the county's own downturn-related budgetary shortfalls.<sup>22</sup> Plans to improve and expand the county jail have been halted, for instance, forcing Graham to use its already scarce resources to transport female prisoners to a neighboring county. Similarly, it has had to table a Gila River bridge reconstruction project such that five dozen of its citizens must travel an extra 20 miles to access schools and the nearest community. With reserves gone and no ability to raise taxes, any additional state impacts will necessitate dramatic reductions in full-time county staff, the numbers of which have already been cut by 10 percent.

Meanwhile, Arizona's urban counties have had their own fiscal struggles. The capital county of Maricopa displays what is happening. The County Supervisors Association of Arizona reports that the state has burdened Maricopa County alone with \$116 million in extra expenses since FY 2008, ranging from one-way transfers (to the tune of \$77.3 million), to reductions in shared revenues, to the shifting of responsibilities for certain programs like juvenile corrections. Maricopa has acted swiftly to keep its budget in balance going into the downturn—but its largely successful efforts have come at a hefty price. The number of county staff has been cut by 10 percent since 2007 to approximately 12,500, and it has been forced to make drastic reductions in non-mandated and non-voter-protected services, especially human services. Meals-on-Wheels and the Special Needs Transportation program—which provided home-delivered meals and rides for the elderly and disabled—have both been suspended indefinitely, demonstrating in very real terms how the state's balance sheet problems fall upon its most vulnerable residents.

All of this is hitting counties just as their own revenues, which lag cyclical developments in the economy by about two years, reach their low points. Developing a county budget for FY 2011-12 will be the most challenging yet. In addition to the ongoing legislative impacts enacted to date, local revenues continue to be anemic, and mandated payments to the Arizona long-term care system are expected to shoot up about \$80 million as enhanced federal assistance to the state expires. Making matters worse, eight counties have experienced substantial reductions in their local property tax base (as much as 11 percent) due to home devaluation, creating significant political pressure to reduce property taxes.

As county leaders continue to try to balance dwindling resources with needed local service delivery, they face the unsettling fact that the fate of their operations may largely be determined by how state lawmakers choose to deal with Arizona's fiscal deficit—and the extent to which they will continue to off-load major expenses to the county taxpayer. Their fear is informed by history. In recent years, legislative proposals put on the table included increasing the counties' share of state health care costs, and transferring state juvenile corrections responsibilities and thousands of adult prisoners to county facilities. Though rejected at the time, state leaders just may well entertain similar concepts again. For Arizona counties, then, the worst may be yet to come.

***The state has relied disproportionately on temporary or one-time measures to fill its fiscal holes, rather than permanent repairs to the tax and expenditure system—despite the fact that many of the problems are long run in nature.***

And yet, for all the painful moves Arizona has undertaken in the last two years to close its recent budget gaps, little has been done to address the longer-term structural pressures on revenues and expenditures. Instead, the state has relied disproportionately on temporary or one-time measures to fill its fiscal holes, rather than permanent repairs to the tax and expenditure system—despite the fact that many of the problems are long run in nature. For example, the temporary one-cent sales tax rate increase was implemented in 2010 with great controversy to help close a budget gap that was well over \$1 billion. The state also garnered national attention for its asset sales, which included the state Capitol and Supreme Court building. Of the \$12.5 billion in total budget adjustments since 2008, 80 percent of the balancing act has been realized by one-time measures.<sup>11</sup>

Yet now that the “easier” options have been exhausted, starker choices are coming, both today as well as during the next economic downturn.

Speculation now abounds that the K-12 and university systems will bear the brunt of substantial new cuts—a potential disaster as Arizona tries to position itself to diversify its economic base and develop the sort of high-impact, good-paying industries that require a top-quality “job-ready workforce.”

What is more, Arizona’s budget situation—like that in other states—is likely to get worse before it gets better. In fact, the Government Accountability Office (GAO) projects a continued deterioration in the state’s budget outlook for decades to come absent fundamental policy changes that address core imbalances between revenues and spending.<sup>12</sup>

There are several interrelated reasons for this. First, it will take years for levels of economic activity and revenue yield to return to their pre-recession peaks. While some recent projections are a bit more optimistic, job growth will likely remain anemic and unemployment rates stubbornly high for a number of years. At the same time, with consumption down and purchases of untaxed services (as a share of all purchases) up, sales tax growth is likely to be muted. Overall, it is likely that the revenue side of the state’s budget will not fully rebound until at least 2013 or 2014.

Second, however dire the state’s fiscal situation may become, with the withdrawal of federal fiscal stimulus funds in 2011—estimated to have provided \$2.4 billion to the state in both stimulus and enhanced match for Medicaid since 2008—and little chance of further relief in store, the state will almost certainly be on its own to deal with its obligations and existing mandates.<sup>13</sup> The increased federal matching rate for Medicaid spending will also end in 2011, for example, and absent the full restoration of state revenues, more service cuts can be expected. All told, Arizona is looking at the loss of \$800 million in federal Medicaid funds in 2011. The Center on Budget and Policy Priorities estimates that eliminated services have already impacted approximately 1 million enrollees.<sup>14</sup>

And then there is the potential for new federal mandates—a third unwelcome possible development. A case in point is the higher health care costs associated with national health insurance reform. While reform will achieve the goal of bringing large numbers of the uninsured into the service net, it offers no effective means of fostering health care cost containment. Moreover, a significant financing burden will be shifted to the states after the initial period of transition.

In sum, while cyclical surpluses will return to Arizona—eventually and temporarily—the stark fact remains that the state and its peers face a very bleak fiscal prognosis. Even when revenues do eventually recover to pre-recession peaks, the state will face a pent-up demand for the full range of long-reduced public services, at the same time that it must address the crucial need to replenish its emptied rainy day fund.<sup>15</sup> Aggravating these burdens will be demographic trends, including more children to serve in the public schools, and a growing, aging population in need of increasingly expensive health care services. Finally, mounting pressures outside of the state general fund, particularly from pensions, will reduce the funds available to support other areas of the budget.<sup>16</sup> All the while, rising anti-tax sentiment will make it exceedingly difficult to raise taxes or broaden tax bases to pay for growing encumbrances, however essential or unavoidable they may be.

## VI. Narrowing the Gap: Reducing Cyclical and Structural Budget Deficits and Improving Arizona's Fiscal Stability

The cyclical and structural deficits confronting Arizona are enormous. Arizona must look within and make wise and strategic policy choices to address these fiscal imbalances, including not just strategic program cuts, but also the tax reforms essential to improving revenue streams over both the immediate term and for the long haul.

And so the state needs to break with its past budgeting habits and move urgently to inaugurate more prudent, strategic, and better-informed tax, spending, and budget planning practices. To this end, a broad principle should be embraced that would insist that permanent policy changes on one side of the budget must be matched by permanent policy changes on the other side of the budget.

More specifically, there are two sorts of steps that need to be taken to begin reducing the state's present structural gaps and prevent their return. Within these two areas, a few recommendations are here offered, not as a complete response to the state's massive problems, but as discussion-starters:

**First, Arizona leaders need to improve the quality of fiscal policymaking by steadily working to broaden, balance, and diversify their revenue bases while looking to the long-haul fit of taxing and spending.** Questionable past policy decisions have played a large role in the emergence of significant structural deficits in Western states. It follows, therefore, that improved policymaking represents the key to improved fiscal stability going forward. To that end, lawmakers in Arizona should embrace a number of widely recognized tenets of good management that ensure appropriate responses to a fluid economic and fiscal environment, including the ability to meet changing and newly emerging budgetary needs. These tenets should motivate a number of concrete actions:

**Commit to a balanced approach.** Lawmakers should embrace balance as a watchword as they seek to stabilize year-to-year finances and narrow structural gaps. One sort of balance should be a balance of revenue- and spending-side responses. The state's massive budget gaps simply cannot be responsibly closed with only spending reductions. A second sort of balance is that which arises from diversification of the tax system. The proliferation of tax reductions implemented in the state since the early 1990s have made the revenue system not only narrower, but also more vulnerable to cyclical variations in the economy. State leaders need to commit to a more balanced approach and to making the hard choices on both the spending and revenues sides of the budget to achieve it.

**Broaden tax bases and improve their responsiveness.** Tax policies that increase the base and elasticity of state tax systems would help mitigate structural deficits and reduce the need for discretionary rate increases. For example, expanding the sales tax base to include more consumer services would both account for the growing importance of services in the economy and increase the tax's revenue yield. When the tax system was originally established in Arizona, leaders could not foresee the growth, and in some ways dominance, of the service economy. The tax system in place today does not capture the true economic activity in the marketplace. Now, of course, it is true that elastic tax systems are a two-edged sword, producing strong revenue gains when the economy grows but also contracting sharply during recessions. Going forward, therefore, the new revenues could be used to enhance rainy day fund balances to bring greater stability to the overall system.

**Increase local flexibility and control.** State legislators and voters (via statewide ballot initiatives) have a history of passing measures that constrain local governments' ability to raise revenues and respond to changing fiscal circumstances. For example, capping the property taxes that localities are permitted to levy—a measure imposed by Arizona's state legislature on localities—severely constrains local fiscal flexibility. Local governments exist in an asymmetric relationship with states as well: They are dependent on states for large

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portions of their budgets and can be forced via state mandates to pick up unexpected tabs, as they have been in Arizona. (See sidebar.) In a 2008 National League of Cities report, Christopher Hoene and Michael Pagano offer a series of recommendations that can accommodate greater local control over revenue generation and public service provision, including access to a variety of general tax instruments (sales, property, and income), increased state aid, and fewer tax and spending limitations.<sup>17</sup> Such adjustments will also build balance into the combined state-local system and allow flexibility when it is needed.

Additionally, providing more flexibility to the state legislature through modification of “voter-protected programs” appears another way to create a more responsive system. Currently, many of these programs exist, in perpetuity, without review or consideration of new and emerging fiscal needs. Options to still respect the will of the voters, but provide more room for adaption to changing circumstances, include requiring voter-approved programs to have a sunset provision, and/or requiring voters to actively reevaluate and reauthorize a program after a set time period in order for it to continue.

**Second, state leaders need to improve policymaking by institutionalizing better budget processes and information sharing.** There are no easy answers to complicated budget puzzles. And for that reason, sound processes and quality information about real and projected conditions and the range of policy options and their consequences are critical to improved policymaking. In order to reach a sustainable fiscal trajectory, then, Arizona should move to:

***Report budgets in a transparent manner.*** Arizona should commit to reporting critical budget data in a user-friendly format along with interpretative narrative on state government web pages. Transparency is essential to accountability and sound decisionmaking. Therefore, copious data should be easily available online. Budget guides for the public and legislators should explain in clear language historical budget patterns, current budget policy issues, and the long-term pressures on public finances.<sup>18</sup> Such information will help lawmakers and the public understand the implications of their decisions for the state’s budget future.<sup>19</sup>

Additionally, budget packages should be available for public review, and the process should allow appropriate time for public comment. Many budgets, while discussed publicly in the abstract, come together in the 11th hour, and are passed quickly and with little public input.

***Move to multi-year budgeting.*** Fiscal year budgets and two- and four-year election cycles can easily be in conflict with one another. The state’s approach to capital budgeting, moreover, offers little clarity on investments, their return, and the consequences for long-term financial obligations; sinking funds and schedules of debt liability repayment exist, but these do not fully rationalize capital spending in the eyes of the public. As the National Association of State Budget Officers notes, the capital budgeting plan is just one year in Arizona compared to nine years in Nevada.<sup>20</sup> Short time frames for capital budgeting simply do not make good sense from a planning and long-term financial perspective. Another example is Arizona’s expanded Medicaid coverage, passed in 2000. This relied on tobacco settlement funds. At the time, this funding source appeared to provide the fiscal support the program required, though as years have passed and that funding has fallen, the cost to the general fund continues to grow. This program in particular could have benefited from review and planning through the lens of multi-year budgeting. Transparency using fully integrated capital and multi-year budgets would help demonstrate the long-term consequences of prevailing fiscal policy as well as changes to the tax/expenditure mix.

**Arizona does not have a strategic plan, articulating a vision with measurable mileposts.**

***Craft a statewide strategic plan, driven by measurable goals.*** Arizona does not have a strategic plan, articulating a vision with measurable mileposts. When a state has definable goals within a plan framework it improves the ability of policymakers to make difficult decisions by keeping the state's long-term goals in mind, protecting them in an effort to keep the state moving forward on a positive trajectory even in the worst of times, and positioning the state more strongly for eventual economic recoveries.

A key consideration in crafting a strategic plan is to include as a fundamental premise the need to take actions that will encourage and sustain economic development. Solutions could include re-examination of the corporate tax as well as an analysis of the role of fiscal incentives. It should also address infrastructure, education, and workforce development. Paramount is the recognition that economic development has to be part of any statewide vision and that the state's fiscal structure must be consistent with, and support, economic development objectives.

***Improve tax expenditure reporting.*** Giveaways of the tax base in the form of new and ongoing exemptions and incentives that typically receive no formal budgetary accounting are key contributors to state structural distress. Such giveaways include services largely exempt from sales tax bases, discretionary incentives to promote economic development, and preferences granted under personal and corporate income taxes. Arizona does not provide any forward-looking estimates of tax expenditures nor does it provide any narrative explaining why the expenditures were put in place.<sup>21</sup> Data on these costs would allow citizens and policymakers to observe the near-term and long-term consequences of exemptions to state taxation—and ultimately help reduce giveaways and loopholes.

***Educate citizens about the fiscal implications of referenda.*** Important as they are, voter mandates can have unintended, or at least not well understood, budgetary consequences, particularly when economic, demographic, and/or fiscal conditions shift after the initiatives are approved. State governments should work with universities and other groups to provide unbiased, readily accessible, and transparent information to voters on how proposed referenda are likely to impact budgets in the short- and longer-term so that they can carefully weigh the benefits of new mandates against their fiscal implications before making their decisions at the ballot-box.

## **VII. Conclusion**

Arizona is at a critical point. The state has always relied on its next growth spurt to pull it out of any downturn and keep the revenues flowing. This time is different. This time the budgetary problems are deeply entrenched, the choices painful, and there is no quick fix in sight.

In the end, inaction is not an option. Evasion and delay will only lengthen the present crisis at a time when Arizona needs to renew the economic progress of the state and its residents.

Tomorrow's innovative industries will not want to stay or locate in a state with dismal K-12 funding and performance, a mediocre university system, and a devastated social safety net. Therefore, making the hard choices necessary to bring into balance necessary spending and adequate revenue raising stands as the necessary first work of launching the state into its second century.

If Arizona is to position itself as a seedbed and hub for vibrant business, new economies, and economic growth, a stable, predictable, and balanced budget is essential. And to achieve that, leaders must accept the need to balance the need for discipline on expenditures with the need for adequate revenues.

## Endnotes

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Brookings Mountain West has been made possible by the generous support of The Lincy Foundation.

### **Acknowledgments**

The authors wish to thank Tom Rex and Dennis Hoffman at the Center for Competitiveness and Prosperity Research for thorough research and incisive analyses that helped inform this paper. We are heavily indebted to them. Craig Sullivan, Tom Belshe, Rick Bohan, and Terry Cooper in Arizona, all provided invaluable local insights. The authors wish to thank William Brown, Christopher Hoene, Liz McNichol, Robert Lang, and Michael Pagano for their careful review of the paper and thoughtful comments. ASU's Joe Garcia provided critical editing support. David Jackson at Brookings and Zara Gort at ASU lent their editing and design expertise, respectively, and Kenan Fikri provided substantial research assistance.

The authors would also like to thank as always Neal Smatresk at UNLV as well as numerous leaders in the Mountain Metros who have informed this work.

### **For More Information**

**Sue Clark-Johnson**, Executive Director, Morrison Institute for Public Policy  
[susan.clarkjohnson@asu.edu](mailto:susan.clarkjohnson@asu.edu)

**Mark Muro**, Washington Director, Brookings Mountain West  
Senior Fellow and Policy Director, Metropolitan Policy Program at Brookings  
[mmuro@brookings.edu](mailto:mmuro@brookings.edu)





