DIGGING THE HOLE DEEPER

Too Many Tax Cuts Are Hurting Arizona

CHILDREN’S ACTION ALLIANCE

October 2009
It is no surprise that Arizona’s state revenue coffers have been shrinking before our eyes. Arizona has been hit hard by the U.S. financial crashes, suffering one of the highest rates of home foreclosures and job losses of any state in the country. In fact, Arizona ranks 5th for the State Economic Distress index which looks at housing foreclosures, unemployment, and food stamp participation. It is up to our state leaders to deal with the pain and the challenges of economic forces that were largely outside of their control.

But there’s another large and growing hole in Arizona’s revenue bucket that is under the control of our governor and state legislature. This is a hole created by year-after-year of tax cuts that shrink revenue to the state’s general fund and shrink our ability to secure our common benefits. Tax cuts passed nearly every year have removed millions – and now billions – from the general fund. Even now as our lawmakers struggle unsuccessfully to close the gap of our staggering budget deficit, the tax cut “hole” continues to get bigger. Laws with delayed or phased-in effective dates continue the erosion of Arizona’s tax base. And – amazingly – tens of millions dollars in new tax cuts were passed during the 2009 legislative session, even as state revenues continued record-breaking drops month after month.

In 1991, the general fund collected $4.85 in state taxes for every $100 of personal income in the state; in 2008, general fund tax collections had fallen to $3.91 per $100 in personal income.

As the hole in Arizona’s revenue bucket gets larger, it threatens to tear apart the infrastructure that will build our future. The year-after-year tax cuts and boom-and-bust state revenue roller coaster erode the stability and predictability that Arizona needs to help both businesses and families succeed.

As the economy begins to recover, we can help our state climb out of the fiscal hole by stabilizing our tax base to match our economy and to meet our expectations for health, education, and security.
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A QUALITY TAX REFORM PACKAGE MIGHT CUT SOME TAXES, BUT ONLY IF COMBINED WITH OTHER REVENUE INCREASES

Arizona's tax system has many weaknesses, including some areas that are far too complex, outdated, and out of line with other states.

Over the years, workgroups and commissions and interest groups have presented a range of very solid recommendations for tax reform to make our tax system simpler and better-suited to our economy and our common goals.

A quality tax reform package may include some cuts in specific tax rates or changes in definition of who and what is taxed. But these should be combined with other changes that increase state revenues and put revenues more in line with our economy. This briefing paper demonstrates why any package that results in a further net loss to the state general fund endangers the common benefits that Arizona counts on.

ARIZONA’S REVENUE DEFICIT IS HUGE

Due to both the short term economic recession and the longer term gap between revenues and services, Arizona’s revenue deficit is tremendous.

In the middle of FY 09, the legislature filled a $1.7 billion revenue gap. The FY 10 budget is currently $1.5 billion out of balance (which includes a $500 million year end deficit from FY 09 and the changes from the Governor’s vetoes). This is dwarfed by projected deficits of $2.5 billion in FY 11, growing to $2.8 billion by FY 13. The availability of American Recovery and Reinvestment Act (“stimulus”) dollars helped fill tremendous holes in the FY 09 and FY 10 budgets, but that funding will be exhausted before FY 11 is over. Rollovers and payment deferrals push expenses into future years, but don’t provide a permanent solution.

ARIZONA HAS CUT TAXES STEADILY FOR SINCE 1990s

The taxes that we pay support the common assets that we value – like education, health care and infrastructure. Over the years, Arizona’s tax cuts have been financed by cutting these very services.

Since 1989, tax cuts have been passed every year except one (2003). The chart below shows the revenue impact to the state general fund from tax policy changes made in 1990 and beyond. Beginning in FY 1996, the bars on the chart go downward below zero, indicating a net loss to the general fund. By the current fiscal year, this loss totals nearly $1.4 billion during the year. That is projected to grow to more than $1.5 billion by FY 2012 – if we make no additional tax cuts after today.

During the mid-1990s, we made significant cuts to individual income taxes. These same taxes were cut further a decade later. The corporate income tax was cut with a change in the formula on which the taxes are based (the so-called “single sales factor” formula). The statewide property tax, known as the equalization tax, was suspended for three years. The FY 10 budget is currently $1.5 billion out of balance (which includes a $500 million year end deficit from FY 09 and the changes from the Governor’s vetoes). This is dwarfed by projected deficits of $2.5 billion in FY 11, growing to $2.8 billion by FY 13. The availability of American Recovery and Reinvestment Act (“stimulus”) dollars helped fill tremendous holes in the FY 09 and FY 10 budgets, but that funding will be exhausted before FY 11 is over. Rollovers and payment deferrals push expenses into future years, but don’t provide a permanent solution.

The combination of narrowing the tax base and lowering rates has had a cumulative, negative impact on our state’s revenues.
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The statewide property tax, known as the equalization tax, was suspended for three years. The assessment ratio for commercial property taxes was phased down to cut property taxes for businesses. Both of these property tax changes mean fewer property tax dollars going to school districts and increased costs to the state general fund to make up the difference. The assessment ratio change was a loss to the state general fund of $12.3 million in FY 07, growing to $140.0 million in FY 12.

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Arizona is coming up short when it comes to the public assets families and businesses need to prosper.

Arizona suffers from high class sizes in public schools and very low proficiency in basic reading and math skills. In rankings of business climate, Arizona fares the worst in the categories of education and quality of life. Arizona ranks 47th in the nation in the performance of our child health system and lacks quality, affordable child care options to support early education and workforce stability. We face $288 billion in unfunded infrastructure costs over the next 25 years to meet the growing needs of residents and business, including transportation, water, public health, education, and public safety.

Overall state and local taxes in Arizona are not high.

In 2007, we ranked 20th in combined state and local taxes per $100 of personal income. This is down from our ranking at 9th highest in 1990. The tax cuts that resulted in this drop in ranking are costing the state $1.4 billion per year and growing.

State tax cuts mean cuts in state services.

Because Arizona must have a balanced budget, cuts in state taxes leave less money for health care, education, infrastructure, and security. Proposals for more tax cuts can’t be fully evaluated without identifying the associated cuts in spending and their consequences.

Tax cuts can drain Arizona’s economy.

Tax cuts and budget cuts lead to losses in Arizona jobs in teaching, construction, health care and many other industries—and dollar-for-dollar cuts to money flowing through local economies. While tax cuts can leave the recipients with more money on hand, not all of that money will be reinvested in Arizona’s economy: some of the tax cut will be saved, some spent out of state, and some spent to pay down debt. This can leave a net loss to our state’s economy.

Arizona taxes are not hampering overall economic growth.

Business and conservative organizations that look at a wide variety of factors rank Arizona as business friendly. In four recent rankings, Arizona was in the top 20 states for business climate.

State tax cuts don’t cause overall economic growth.

While tax cuts may help some individuals and businesses, there is very little link between tax cuts and overall economic growth. A national study found that states that passed large tax cuts during the 1990s generally faced less economic success by the next downturn, including larger budget deficits, more downgrading of their credit ratings, and lower job growth.

An in-depth analysis of Arizona’s state finances by economists at Arizona State University finds no noticeable effect on our economic growth from either past state tax increases or tax cuts. Tax cuts that eliminate assets businesses need can hurt, rather than help, economic success.

There are better ways to encourage economic growth.

Long term investments in transportation, water quality and supply, education, and workforce development have been found to promote economic growth.

These investments continue to bring benefits to the state even if particular businesses shrink or leave.

Continuous tax cuts weaken fiscal stability. Continuous tax cuts create a long-term structural deficit.

This leads to frequent budget crisis and adds to the boom-and-bust roller coaster of our revenues. With everything in flux, both tax policy and state services become uncertain and unpredictable.

Tax cuts shrink our fiscal flexibility and versatility.

Especially because of Arizona’s constitutional requirement for a 2/3 majority vote for any state revenue increase, tax cuts limit our future options and increase our volatility. The money cut in taxes can’t be set aside in a Rainy Day Fund to smooth out the effect of economic downturns. It can’t be used for emergencies like wildfires or flu epidemics. And it can’t be used to pay off debts or reverse past accounting and funding shifts.

Arizona can’t balance its budget.

Arizona’s budget is seriously out of balance and tax cuts will make the situation much worse. The most recent projections from the legislature’s budget office show a deficit of $2.5 billion next fiscal year (2011).
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TAX CUTS CONTINUE TO GROW
The drain to the general fund caused by tax cuts was not stopped when the budget problems started in FY 08. Tax changes previously put into law that called for increasing cuts or delayed effective dates were allowed to continue. These include the second year of the phase-in of the individual income tax rate reduction (2008), the corporate school tuition organization tax credit begun in 2007 that grows 20% every year, and the 10-year phase-down of the assessment ratio for commercial property, passed in 2005 and accelerated in 2007. A new corporate income tax credit for research and development is scheduled to take effect in FY 2011 with a projected $5.7 million annual loss to the state general fund. Not only have tax rates been cut, but the tax base has also been shrunk. The general fund used to receive portions of the property and vehicle license taxes. Today, those taxes no longer feed into the general fund. We are left with sales taxes and income taxes, both of which are highly cyclical when compared to property and vehicle license taxes. An additional blow to the state general fund came from changes in the way Arizona pays to build and repair schools. This used to be financed through local property taxes. In FY 1999, that responsibility shifted to the state general fund – with no new revenues to cover the new costs.

WE NEED WHAT TAXES BUY
Businesses need and value public services – things like education, health care and infrastructure. The lack of sufficient revenue resulting from the tax cuts is now a major threat to services that businesses want and need. One of the factors that help businesses succeed is a plentiful, talented workforce. This means having an education system that produces graduates whose skills meet the needs of a wide variety of employers. Another factor is quality of life. Arizona already has natural attributes such as our climate and varied geography. The attributes that require public investment must be equally as outstanding. These include low crime rates, schools where both business executives and employees want to send their children, and transportation systems that make getting around easy for both business and leisure reasons.

ARIZONA TAXES AND SPENDING ARE NOT HIGH
Overall, Arizona ranks in the middle of the states when it comes to taxes. In 2007, at the beginning of the latest series of significant tax cuts, we ranked 20th in the nation for combined state and local taxes compared to total income in the state. This is down from a ranking of #9 in 1990. Arizona’s individual income taxes and selective sales taxes are low compared to other states. Our general sales tax is in the top ten highest in the nation. Overall property tax collections are in the middle of the pack, masking differences between different types of property. According to a 50-state comparison of 2008 property taxes, Arizona has among the lowest property taxes on homes and apartments. Our property taxes on commercial property put us in the middle of the country, while our property taxes on high value industrial property with machinery, equipment and inventory rank us among the highest ten states. With Arizona’s overall tax structure and with low business costs in other areas, such as labor, Arizona has earned high marks in rankings for state business climate. A variety of recent rankings from business publications and conservative organizations rate Arizona as business friendly compared to other states.

ARIZONA’S BUSINESS CLIMATE RANKINGS
Tax Cuts Don’t Cause Overall Economic Growth

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Source: Calculations from the Center on Budget and Policy Priorities based on preliminary 2007 U.S. Census data.

While tax cuts may help some individuals and businesses, there is very little link between tax cuts and overall economic growth. An Economic Policy Institute study analyzed existing research and confirmed that the costs of taxes are much less important to businesses than other location specific costs, such as qualified workers, proximity to customers and quality public services. The Center on Budget and Policy Priorities analyzed whether large state tax cuts in the 1990s led to economic growth for those states in the early 2000s. The analysis found no positive link between state tax cuts and later economic success. In fact, the big tax-cutting states generally faced larger budget deficits, more downgrading of their credit ratings, and lower job growth than other states that were more cautious about tax cuts. Arizona – one of the top ten tax-cutting states in the 1990s – continued to experience our previous pattern of high job growth in the 2000s, but also suffered one of the largest state budget deficits during the next downturn. An in-depth analysis of Arizona’s state finances and economic growth by the Office of the University Economist at Arizona State University finds no noticeable effect on economic growth from either state tax increases or tax cuts during the last thirty years.
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The drain to the general fund caused by tax cuts was not stopped when the budget problems started in FY 08. Tax changes previously put into law that was not stopped when the budget problems started. A new corporate income tax credit for research and development is scheduled to take effect in FY 2011 with a projected $5.7 million annual loss to the state general fund.

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The lack of sufficient revenue resulting from the tax cuts is now a major threat to services that businesses want and need. One of the factors that help businesses succeed is a plentiful, talented workforce. This means having an education system that produces graduates whose skills meet the needs of a wide variety of employers. Another factor is quality of life. Arizona already has natural attributes such as our climate and varied geography. The attributes that require public investment must be equally as outstanding. These include low crime rates, schools where both business executives and employees want to send their children, and transportation systems that make getting around easy for both business and leisure reasons.

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Fact sheets and Fiscal notes on bills. www.azleg.gov.

TAX CUTS PASSED IN MIDST OF 2009 BUDGET CUTTING BATTLES

$70 Million for Renewable Energy Industries. The legislature created a new incentive program with refundable income tax credits and lowered property taxes for individuals and companies expanding or locating new renewable energy operations in Arizona. Up to $70 million per year can be taken in tax incentives. ($R 1403)

$25 Million and Growing for Corporate Tax Credits for Private School Tuition. The legislation that expanded the School Tuition Organization Tax Credit to insurance companies also removed the sunset of this tax credit which would have been June 30, 2011. The tax credit had a $10 million cap in FY 08 but the cap increases by 20% each year. Without a sunset, the maximum of this credit will more than double every 4 years – the $25 million for FY 12 will grow to $52 million in FY 16. (HB 2248)

$7 Million for Changes to the Charitable Organizations Tax Credit. Changes were made to make it easier for taxpayers to take a credit when donating to organizations that provide assistance to low income residents, chronically ill or physically disabled children. (HB 2286)

$4.3 Million for Lowering the Valuation for Telecommunications Personal Property. The minimum taxable value of personal property owned by telecommunications companies (cables and equipment) is reduced, which will result in lower property taxes for equipment that has been fully depreciated. (HB 2314)

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CHILDREN ARE HURT

More than half of the $1.1 billion in state budget cuts since February 2009 have affected state agencies that serve children and families: AHCCCS, K-12 education, the Department of Economic Security, and the Department of Health Services.

These cuts endanger Arizona’s future by putting up barriers to quality education and putting children in harm’s way.

Examples include:

- Staff reductions for Child Protective Services mean that hundreds of reports of child abuse and neglect go uninvestigated.
- Child care assistance has been closed to working families who apply for help; more than 7,500 qualified children have been turned away since February.
- Nearly 10,000 low-income working parents are losing health coverage because of a budget cut to KidsCare.
- Budget cuts to Children’s Rehabilitative Services mean that parents of 1,200 children with conditions such as cystic fibrosis, cerebral palsy, life-threatening metabolic disorders, and cleft palates now have to pay 100% of treatment expenses—expenses that in many cases are thousands of dollars a month and are not covered by insurance.
- K-12 school budgets have been cut, shrinking dollars for teacher salaries, textbooks, and classroom support.

Arizona’s public assets already leave children behind. Arizona suffers from high class sizes in public schools and very low proficiency in basic reading and math skills. Arizona ranks 47th in the nation in the performance of our child health system and lacks quality, affordable child care options to support early education and workforce stability.

CONCLUSION

Tax cuts over the past fifteen years have grown larger and larger and have crippled the state’s ability to provide the infrastructure and services that businesses and families want and need.

Even as lawmakers have struggled unsuccessfully to close deficits growing to a third of the budget, more tax cuts have been proposed, passed, and phased in. Over and over again, the proposal to ask voters whether they want to temporarily increase the state sales tax has been packaged with large and permanent tax cuts. The resulting loss to the state general fund would outweigh the temporary gain from sales taxes in just a few short years. Children’s health, education, and security would be further hurt by more budget cuts.

And the growing instability of a state that can’t balance its budget would raise interest costs and threaten economic development.

Arizona can rebuild our common assets and plan for our future if lawmakers step up to responsible fiscal policies and stop digging the hole deeper. We can better match our tax policies to our expectations for outstanding education, health and safety for children, and the excellent infrastructure needed for a 21st century economy.

List of Sources

American Legislative Exchange Council, Rich States, Poor States, Laffer State Economic Competitiveness Index, 2009.


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Whittaker Associates, Inc., Predicting Corporate Behavior: Why Companies Relocate or Expand, Dean Whittaker CEcD, President, Whittaker Associates, Inc.
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These cuts endanger Arizona’s future by putting up barriers to quality education and putting children in harm’s way.

Examples include:

• Staff reductions for Child Protective Services mean that hundreds of reports of child abuse and neglect go uninvestigated.

• Child care assistance has been closed to working families who apply for help; more than 7,500 qualified children have been turned away since February.

• Nearly 10,000 low-income working parents are losing health coverage because of a budget cut to KidsCare.

• Budget cuts to Children’s Rehabilitative Services mean that parents of 1,200 children with conditions such as cystic fibrosis, cerebral palsy, life-threatening metabolic disorders, and cleft palates now have to pay 100% of treatment expenses — expenses that in many cases are thousands of dollars a month and are not covered by insurance.

• K-12 school budgets have been cut, shrinking dollars for teacher salaries, textbooks, and classroom support.

Arizona’s public assets already leave children behind. Arizona suffers from high class sizes in public schools and very low proficiency in basic reading and math skills. Arizona ranks 47th in the nation in the performance of our child health system and lacks quality, affordable child care options to support early education and workforce stability.

CONCLUSION

Tax cuts over the past fifteen years have grown larger and larger and have crippled the state’s ability to provide the infrastructure and services that businesses and families want and need.

Even as lawmakers have struggled unsuccessfully to close deficits growing to a third of the budget, more tax cuts have been proposed, passed, and phased in. Over and over again, the proposal to ask voters whether they want to temporarily increase the state sales tax has been packaged with large and permanent tax cuts. The resulting loss to the state general fund would outweigh the temporary gain from sales taxes in just a few short years. Children’s health, education, and security would be further hurt by more budget cuts.

And the growing instability of a state that can’t balance its budget would raise interest costs and threaten economic development. Arizona can rebuild our common assets and plan for our future if lawmakers step up to responsible fiscal policies and stop digging the hole deeper. We can better match our tax policies to our expectations for outstanding education, health and safety for children, and the excellent infrastructure needed for a 21st century economy.

List of Sources
American Legislative Exchange Council, Rich States, Poor States, Laffer State Economic Competitiveness Index, 2009.
Joint Legislative Budget Committee, Arizona State Legislature, variety of budget projections and estimates, and Tax Law Changes by Year, www.azleg.gov/jlbc.
Whittaker Associates, Inc., Predicting Corporate Behavior: Why Companies Relocate or Expand, Dean Whittaker CEcD, President, Whittaker Associates, Inc.
1. **Place a moratorium on all tax law changes** that are scheduled to take effect January 2010 and later. Arizona cannot afford these cuts. A moratorium would keep $1.0 billion from being drained over a five-year period.

2. **Raise the cap on the Budget Stabilization (“Rainy Day”) Fund.** Originally set at 15% of general fund revenues, the cap was lowered and is now 7%. Having larger balances in the Rainy Day Fund can help limit the impact of economic downturns.

3. **Protect the Rainy Day Fund from being raided by creating other contingency funds** that could be used to fund special opportunities or emergencies that are not related to economic downturns.

4. **Make permanent changes to the revenue system** that update the tax code, cause the revenue stream to be less cyclical, and result in revenue growth at the pace of the overall economy.

5. **Make changes that broaden the tax base** but apply low tax rates.

6. **Prohibit laws that cut taxes** with a delayed effective date. When the implementation of tax cuts is delayed or phased in over several years, lawmakers avoid identifying where the budget will be cut. This makes tax cuts appear more affordable and painless than they are.

7. **Put a sunset date on all tax credits and deductions.** Like the sunsets for state programs, this will force the legislature to decide whether or not to continue each credit based on an evaluation of the results and a comparison of benefits to costs.

8. **Implement across-the-board cuts in tax credits.** Just as spending has been cut throughout state government during this time of fiscal crisis, tax credits can be cut as well. This would keep additional dollars in the general fund but allow the tax credits to remain intact once the economic recovery is well underway. *(The Family Income Tax Credit and other credits that are targeted to help low-income families should remain unchanged.)*