What Every Arizonan Needs to Know About Growing Our Economy

January 2017
Questions and Answers: Arizona’s State Budget and Taxes
What Every Arizonan Needs to Know About Growing Our Economy
Arizona Center for Economic Progress

The Arizona Center for Economic Progress advances thoughtful analysis and effective solutions to raise the economic power of all Arizonans with good jobs and strong communities and the policies that create them. We engage a diverse group of partners toward a long term plan that includes great education, balanced tax and budget policies, and robust infrastructure.

Acknowledgements

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State budgets and taxes are the foundation for achieving our common priorities that will lead to more quality jobs, a strong economy, and thriving communities. This publication provides information and analysis to help policymakers, community leaders, and community-based organizations make good decisions about Arizona’s state budget and taxes to reach those goals. These questions and answers highlight key facts and trends about past policies, current challenges, and future opportunities. Together, Arizonans can craft budgets and tax policies that help create better economic opportunities for all of us and our communities.

The Basics

- **What does the state budget look like?**
  The Arizona state budget reflects the state priorities of education, health care and public safety. Each year the state legislature and governor must pursue these priorities with spending and revenue policies that balance the budget—expenditures from the general fund must be less than available revenue.

- **Why does state spending grow faster than the general population and inflation?**
  The populations and costs that shape state priorities are significantly different from the general population or general inflation. Any law or constitutional amendment that ties the complex state budget to a mathematical formula based on general population and inflation is like ordering pizza for five teenage boys based on the appetite of a senior citizen couple living in Sun City.

- **Does Arizona have limits on taxes and spending?**
  Yes. Arizona has both constitutional and statutory limits on spending and revenue increases.

- **What is a structural deficit and why is it important?**
  A structurally balanced budget means that ongoing expenditures are no greater than ongoing revenues. One-time expenditures and one-time revenues are excluded. This includes the balance forward from the previous year, any transfers into the general fund from other fund sources that are not intended to be repeated in future years, and capital outlay and other spending that is considered to be one-time.
Tax Credits: High Growth/Low Accountability

- **What are tax credits doing to the state budget?**

  Tax credits cost the state budget $351 million in fiscal year 2016 and have been growing fast. They compete with state agency budgets for the same pot of funding, but state lawmakers have virtually no accountability or control over tax credits once they are in state law.

Education: Rising Expectations and Shrinking Resources

- **What stands out in K-12 public education funding?**

  Despite the intent of the temporary sales tax to shield education from budget cuts, state investments in charter and district schools have been reduced in numerous ways. State funding per student has dropped 21 percent since fiscal year 2008—even accounting for Proposition 123 funding. Many schools are experiencing crowded classrooms with too few desks and supplies, outdated textbooks and technology, and severe teacher shortages.

- **Are private school tuition tax credits resulting in more low-income families sending their kids to private schools?**

  No. The evidence does not make that case. Despite the significant increase in the amount of private school tuition tax credits claimed and the number of scholarships awarded, the number of students enrolled in private schools in Arizona has remained nearly flat.

- **What has been the impact of state funding cuts on higher education?**

  State funding for Arizona’s three public universities has dropped 56 percent since 2008, when adjusted for inflation, and state funding for the state’s two largest community college districts has been eliminated during that time period. The result is skyrocketing tuition and post-secondary education that is less accessible making it more difficult for Arizona to put forward the trained workforce it needs to attract quality jobs.

Arizona: A Low Tax State

- **Do low-income families pay their fair share of taxes?**

  Yes, all families in Arizona help pay for health, education, and public safety through state and local taxes. Low-income families pay a larger portion of their income in taxes than do wealthier families.
Who doesn’t pay state income taxes?  
Surprisingly, corporations and individuals at all income levels can end up paying little or no state income taxes.

Has Arizona been cutting taxes?  
Yes. All types of taxes have been cut since 1990. Even when factoring in statutory changes that have increased revenues, tax cuts passed since 1990 will cost the state’s general fund more than $2.2 billion in revenues—more than double that when you adjust for inflation.

What would happen if Arizona eliminated the income tax?  
State income taxes for individuals and corporations make up nearly half of all revenues to the state general fund. Eliminating these taxes would have a dramatic impact on Arizona families—including a potentially huge loss of state services or huge shifts in taxes from wealthier Arizonans to middle—and lower-income families.

The Future: Is Arizona prepared?  
Has Arizona recovered from the recession?  
No. While Arizona has recovered the jobs lost during the Great Recession, median family income has dropped by more than $7,000 since 2009 and 25 percent of all Arizona children are living in poverty.

Have budget cuts been restored?  
Most budget cuts to state agencies have not been restored since the recession. The combination of unrestored state agency budgets with one of the nation’s fastest growing populations strains Arizona’s ability to provide the important services its residents expect from their state government to maintain good roads, ample water resources, safe neighborhoods and all of the other services they need to thrive.

How have the budget trends affected the safety net?  
Arizona has a history of bipartisan support for policies that provide temporary help to prevent hunger, homelessness, illness, abuse and neglect. All of these can have lifelong consequences for children and high costs for taxpayers. Budget cuts have weakened the safety net and resulted in expensive emergencies for the state to handle.

Challenges Ahead
The Basics

In This Section:
- What does the state budget look like this year?
- Why does state spending grow faster than the general population and inflation?
- Does Arizona have limits on taxes and spending?
- What is a structural deficit and why is it important?

What does the state budget look like this year?
The Arizona state budget reflects the state priorities of education, health care and public safety. Each year the state legislature and governor must pursue these priorities with spending and revenue policies that balance the budget—expenditures from the general fund must be less than available revenues.

K-12 education, AHCCCS (Arizona’s Medicaid program)/Health Services, and the Department of Corrections make up 72 percent of the $9.6 billion appropriated from the state general fund for this fiscal year. The Departments of Child Safety and Economic Security along with the universities make up another 17 percent. The last 11 percent of the budget goes to more than 50 agencies that receive some or all of their funding from the general fund. Most of these services involve consumer protection, including the Department of Financial Institutions and the Department of Veteran’s Affairs. The Department of Transportation and all spending for state highways comes from the state gas tax and is not part of the general fund budget.

How the General Fund Is Spent, FY 2017
(Dollars in Millions)

Source: Joint Legislative Budget Committee Staff, Appropriations Report FY 2017.
The fiscal year 2017 budget essentially leaves Arizona stuck in neutral. It does not rebuild any of the major pieces of the budget that were cut during the great recession. For K-12 education, the additional revenue from the passage of Proposition 123 only restores funding due for past automatic inflation adjustments. The budget contains no new investments in sustaining teachers, repairing crumbling school facilities or updating classroom textbooks or technology.

The budget delays by one year $38.6 million in K-12 funding cuts that were scheduled to take place in fiscal year 2017. These would eliminate funding for district-sponsored charter schools, phase out additional funding for multisite charter schools, and reduce funding for districts with declining enrollment in the year in which the decline first occurs, rather than taking the reduction in the following year. The legislature decided to add these funds back into the fiscal year 2017 budget when it became apparent that, for those schools and districts affected, the cuts would wipe out any gains from Proposition 123. But unless the legislature takes action again to delay these cuts, they will take effect in fiscal year 2018.

The fiscal year 2017 budget also includes more than $35 million in new, permanent, ongoing tax cuts. As has happened frequently during and since the Great Recession, several of these tax cuts are not fully annualized until several years later. The $35 million in tax cuts will exceed $66 million by fiscal year 2019.

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**Corporate Income Taxes are Projected to be One-Fourth of What They Were in 2007**

(Dollars in Millions)

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* Estimates and Projections
Source: Finance Advisory Committee meeting, October 5, 2016
Tax cuts passed in prior years are also not fully annualized. In fiscal year 2017, corporate income tax revenues are projected to be $97 million lower as a result of tax cuts passed since 2017; by fiscal year 2020, these same tax cuts are expected to result in $268 million less in revenues.

The state has built up $2.6 billion in general fund debt with annual payments of principal and interest that must be funded every year—like paying a mortgage. The annual debt payments combined are $369 million—just under the $379 million general fund appropriated to the Department of Child Safety.

Arizona also has $1.6 billion in unfunded obligations. These include delayed payments, an accounting gimmick, known as “rollovers,” that pushes the payment of certain bills into the following fiscal year. They can continue year after year until enough funds are available to reverse them. In addition, a number of budget formulas in state law are unfunded. These formulas are put into state law to automatically adjust specific types of spending for certain factors every year, such as inflation or growth in people needing the service. The legislature has eliminated some of these formulas from state law and they are not included in the $1.6 billion. Others remain in state law, but go without funding in the budget.
Why does state spending grow faster than the general population and inflation?

The populations and costs that shape state priorities are significantly different from the general population or general inflation. Any law or constitutional amendment that ties the complex state budget to a mathematical formula based on general population and inflation is like ordering pizza for five teenage boys based on the appetite of a senior citizen couple living in Sun City.

In 1992, Colorado passed the so-called Taxpayers Bill of Rights (TABOR), which uses the formula of general inflation plus the annual change in population to limit state spending. Over 20 states, including Arizona, have considered and rejected putting these TABOR formulas into their budget process. It was such a disaster for the economy, schools, roads, healthcare, and public safety that Colorado voted to suspend it. State business leaders agree that TABOR led to slower job growth and delayed recovery from recessions.

Population: Many of the groups that drive the state budget grow far faster than the statewide population, including prison inmates, community college and university students, children in foster care, and children and adults participating in services for developmental disabilities.

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<table>
<thead>
<tr>
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<th>2000-2016 Growth</th>
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<tbody>
<tr>
<td>Statewide Population</td>
<td>34%</td>
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<tr>
<td>K-12 Students</td>
<td>31%</td>
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<tr>
<td>Prison Inmates</td>
<td>37%</td>
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<tr>
<td>University Enrollment</td>
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<tr>
<td>People Receiving</td>
<td>59%</td>
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<tr>
<td>Development Services</td>
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<tr>
<td>Kids in Foster Care</td>
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<td>AHCCCS Participants</td>
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Inflation: The mix of costs that go into measuring inflation is far different from the mix of costs that affect state spending. For instance, education—from kindergarten through post-secondary education—makes up 50 percent of Arizona’s budget, while education is only 3 percent of the cost that goes into determining the Consumer Price Index (CPI). Medical costs make up only 8 percent of the CPI, while AHCCCS/ Medicaid/ Health Services make up 19 percent of state spending. On the other hand, food and beverages make up 15 percent of the CPI, while only a handful of state agencies, such as the prisons and the Arizona Pioneers Home, have food costs in their budget.
Does Arizona have limits on taxes and spending?

Yes. Arizona has both constitutional and statutory limits on spending and revenue increases.

- The Arizona constitution contains an appropriation limit that applies to all appropriated funds, not just the state’s general fund. This limit is based on the size of the overall state economy. Currently the limit is 7.41 percent of the total state personal income. Arizona’s appropriations have remained well below the constitutional limit with actual appropriations falling from 6.56 percent in 1990 to 5.66 percent in 2016.

- The Arizona constitution also requires that any legislation that would increase state revenues must be approved by a two-thirds majority. This encompasses not only adopting new taxes or increasing rates on existing taxes, it also includes any reduction or elimination of tax deductions, credits, exemptions or exclusions. On the other hand, passing tax cuts, adopting or expanding new credits, or any other action that reduces state revenues requires only a simple majority vote.

- Article 9, Section 3 of the Arizona constitution requires the legislature to provide sufficient sources of revenue to defray the ordinary expenses of the state for each fiscal year. In other words, the state budget must be balanced every year.

**Arizona’s Appropriations Have Remained Well Below the Constitutional Limit**

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<th>Year</th>
<th>Total Appropriations as Percent of Total Arizona Personal Income</th>
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<tr>
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<td>'15</td>
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<td>'16</td>
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**Constitutional Limit**

7.41%

**Source:** Joint Legislative Budget Committee Staff, *State Appropriations Limit*, February 12, 2016.

**NOTE:** The statutory limit is adjusted whenever government functions or funding responsibilities transfer between levels of government.
What is a structural deficit and why is it important?

A structurally balanced budget means that ongoing expenditures are no greater than ongoing revenues— one-time revenues, including the beginning balance that carries over from the prior fiscal year, are not included, nor are one-time expenditures such as capital projects. The Arizona constitution requires that the budget be balanced from a cash perspective, but is silent regarding structural balances. The last time Arizona’s budget was structurally balanced was FY 2007.

A budget that uses one-time funding to pay for ongoing expenditures can quickly result in a budget crisis if the economy slows. When there is a gap between appropriations and projected revenues, the governor and legislature must close the gap by cutting spending, sweeping other funds, and other short-term solutions that don’t take into account long-term impacts.

A budget balanced based on “one-time” spending cuts, transfers into the general fund from other fund sources that are not intended to be repeated in future years, depleting a carry-forward balance, or phasing in new tax cuts with a minimum impact the first year are all measures that affect the structural balance over time and create challenges to balance the budget in future years. For example, the FY2017 budget adds more than $37 million in new permanent, ongoing tax cuts. Several of these tax cuts are not fully annualized until fiscal year 2019, with the cost to the general fund exceeding $70 million by fiscal year 2019.
What are tax credits doing to the state budget?

Tax credits cost the state budget $351 million in fiscal year 2016 (excluding credits for taxes paid to other states, family income credit, and increased excise taxes) and have been growing fast. They compete with state agency budgets for the same pot of funding, but state lawmakers have virtually no accountability or control over tax credits once they are in state law.

A tax credit reduces the amount of taxes owed on a dollar-for-dollar basis—a $400 tax credit can wipe out a $400 tax bill. The dollar value of tax credits claimed is growing at a much faster rate than state revenues, the state’s economy, or state spending on K-12 education.

In each legislative session since 2005, at least one new tax credit has been added or expanded. Between 2010 and 2016, even as state revenues remained low due to the recession, eight new credits were created. Today there are 33 credits available to individuals and 22 available to corporations.

Source: Joint Legislative Budget Committee staff, Appropriations Reports for FY 1999 and FY 2017; Department of Revenue, Arizona Income Tax Credits, October 2016; Bureau of Economic Analysis.

**Tax Credits Are Growing Fast—Percent of Growth 1999 to 2016**

- General Fund Revenues: 70%
- State GDP: 90%
- K-12 Education General Fund Appropriations: 78%
- Tax Credits Claimed: 322%
Tax credits lack the basic accountability and control that state spending has. Unlike agency budgets that must be approved by the state legislature every year, tax credits are reviewed only once every five years. Even after a review that shows questionable results, tax credits continue forever unless a bill to repeal them passes with a two-thirds vote in both the house and senate. While state agency spending is capped at the appropriated amount, only 7 out of the 55 credits have an aggregate cap. State legislators don’t know what the fiscal impact of any tax credit will be in any particular year until after the credit has already been taken.

The expansion of the private school tuition tax credits in particular is having a significant impact on state revenues. Arizona now has two individual and two corporate tax credits for contributions to “student tuition organizations” that use the funding to grant scholarships for private school tuition. Combined, the amount claimed for these four credits rose from under $14 million in 1999 to $129 million in 2016. The largest of the corporate tax credits (shown below) has an aggregate cap that grows by 20 percent each year and has been maxed out in the last several years.

![Corporate Private School Tuition Tax Credit Grows by 20 Percent Each Year](chart)

Source: Arizona Department of Revenue, Arizona Income Tax Credits, August 2016; calculation by Children’s Action Alliance.
Another feature that puts tax credits outside legislative budget control is the carry forward balance that taxpayers are allowed to accumulate and use in future years. For most tax credits, if taxpayers don’t owe enough income taxes to use the whole credit, they are allowed to save the unused portion of the credit and apply it against future tax liability. For instance, if a taxpayer owes $300 in taxes and has contributed $400 to the charitable organizations tax credit, the $100 unused portion of the credit can be carried forward and used on next year’s tax return. The number of years a tax credit can be carried forward ranges from 5 to 15 years.

Today, individuals and corporations are carrying forward a combined $1.1 billion balance in tax credits that can hit the state budget at any time. This carry-forward amount is three times greater than the credits claimed in any single year. The carry-forward balance for corporations is expected to grow because the amount of corporate taxes due will decrease with the phasing down of the corporate tax rate.

Arizona Taxpayers Have Built Up Over $1 Billion in Tax Credits That Carry Forward to Future Years
Combined Individual and Corporate Income Taxes

Source: Arizona Department of Revenue, Tax Credit Report, October 2015.
In the Alliance Bank 2016 CEO Survey, Arizona’s business leaders said the funding of a quality public education system and availability of a trained workforce are the top two challenges to doing business in Arizona. Without adequate resources, Arizona’s public schools will struggle to produce the strong educational outcomes we want all students to achieve in order to create more quality jobs and better economic opportunities for all. Arizona has cut $1.5 billion in annual funding from public education since 2008. With a growing teacher shortage crisis, aging school buildings and buses, and under-resourced classrooms, fixing Arizona’s school funding issues will require putting an end to revenue-draining tax cuts and credits combined with substantial new revenue.

What stands out in K-12 public education funding?

Despite the intent of the temporary sales tax to shield education from budget cuts, state investments in charter and district schools have been reduced in numerous ways. State funding per student, adjusted for inflation, has dropped 21 percent since fiscal year 2008—even accounting for Prop 123 funding. Many schools are experiencing crowded classrooms with too few desks and supplies, outdated textbooks and technology, and severe teacher shortages.

By any measure, Arizona’s K-12 education funding (adjusted for inflation) has dropped. Trends in funding from state, local and federal sources are shown on page 27.

From a national perspective U.S. Census data from 2014 ranks Arizona in the bottom five states for various measures of revenue and spending per student. Arizona also ranks fifth worst in the country in the depth of cuts to school funding since the start of the recession (see Michael Leachman, Kathleen Masterson, and Marlana Wallace, After Nearly a Decade, School Investments Still Way Down in Some States, October 20, 2016 ). Arizona has cut investment in K-12 schools, per student, adjusted for inflation, by 12.8 percent since 2008—putting us behind Oklahoma, Alabama, Kentucky and Kansas. Twenty-four states have increased education funding since the recession.
The budget cuts to education come at the same time that lawmakers and taxpayers have been raising expectations for schools, teachers, and students. The expectations for student achievement have been growing while the tools to meet those expectations have been shrinking.

Examples of major cuts to K-12 education include:

- Lawmakers eliminated state funding for full-day kindergarten. Schools now receive funding for half-day kindergarten only; districts can offer full-day kindergarten but have to pay for it either by cutting spending somewhere else or charging tuition.
- The "building renewal" funding formula for schools to repair and maintain school buildings was repealed from state law as part of the fiscal year 2014 budget and replaced with a grants program that is less than one-tenth of what the formula had called for.
- The state budget suspends a portion of the additional assistance formulas that pay for textbooks, computers, technology, classroom supplies, etc. District schools will receive only $63 million instead of the full $445 million required by the formula, while charter schools will receive $291 million instead of $310 million.
The passage of Proposition 123 was the final piece in settling a lawsuit called Cave Creek v. Ducey, in which the Arizona Supreme Court ruled that the state legislature violated a voter mandate by only partially funding inflationary adjustments. The funding from the resolution of this lawsuit only restores 18 percent of the funding that has been cut from Arizona’s public schools since 2008. A majority of the funding for the settlement will come from the state land trust. This is a trust fund that consists of proceeds from the sale of lands deeded to the state when it entered the Union in 1912, as well as earnings from those proceeds that have accumulated over time. The settlement required voter approval as provided by Proposition 123 because it changes certain portions of the Arizona Constitution regarding the inflation requirement as well as the distribution of the state school and land trust.

Policy and political discussion about education funding often center on whether school districts are spending tax dollars wisely and getting the money to where it matters most for children. In a March 2016 report, the Arizona auditor general noted that on a statewide basis, administrative spending by school districts is low. "Compared to national averages, Arizona districts spent less on administration because they paid lower salaries to administrators and support staff and/or employed fewer of them."

In fact, according to the U.S. Census Bureau, Arizona had the third lowest administrative spending per K-12 student in 2014, including both school and district administrative expenses.

There has been a lot of criticism of public schools for not spending more of their dollars on "classroom instruction." It’s true that Arizona’s spending per student for classroom instruction is lower than the national average. And due to low state education budgets, Arizona’s spending per student is lower than the national average in every category of school spending. In 2014, Arizona schools spent a total of $7,528 per student—only two thirds of the national average of $11,009.

A narrow focus on classroom spending ignores budget areas that are directly linked to student success. For example, spending in "student support services" is not considered classroom spending, but it directly supports student learning and achievement. This spending pays for speech, audiology and occupational and physical therapy services for students as well as health, psychological services, attendance, social work and guidance. Spending needs for these services vary depending on the percentage of students who live in poverty or have special needs.

Similarly, spending on instructional support" is not counted as classroom spending but pays for teacher training, curriculum development, and library, media and technology services, all designed to improve classroom instruction.

Other areas of the budget are equally vital to students’ daily learning, such as food services, transportation, and capital funding for school facilities, equipment, and technology.
Are private school tuition tax credits helping more low-income families choose private schools?

No. The evidence does not make that case. Despite the significant increase in the amount of private school tuition tax credits claimed and the number of scholarships awarded, the number of students enrolled in private schools in Arizona has actually declined from 79,779 in 2007 to 78,275 in 2015.

The number of scholarships awarded has increased as a result of the tuition tax credits, but there is not enough information to know if that translates into more students receiving scholarships or, instead, students receiving multiple scholarships. We also don’t know how many students receiving scholarships had previously been enrolled in public schools.

Who benefits from private school tuition scholarships matters because these tax credits accounted for $129 million less in state revenue in 2016, revenue that could otherwise be invested in our public schools. That revenue loss brings the state no value if the primary beneficiaries of the private school tuition scholarships are families who already have the means to attend private schools.

Based on the average scholarship amount reported to the Department of Revenue, it is clear that many scholarships are far below the cost of tuition, not to mention books, activities, and other fees that are not covered by the scholarships.
According to the Department of Revenue, the average scholarship in Maricopa County in 2015 was $1,812 while the average, low-end tuition at Maricopa County’s top twenty-five private schools as identified by the Phoenix Business Journal is $7,569. This means that cost remains a large barrier for low income families. According to the Department of Revenue, less than half of the scholarship funds awarded went to children in low income families (families with incomes below 185 percent of the federal poverty level).
What has been the impact of state funding cuts on higher education?

State funding for Arizona’s three public universities has dropped 56 percent since 2008, when adjusted for inflation, and state funding for the state’s two largest community college districts has been eliminated during that time period. The result is skyrocketing tuition and post-secondary education that is less accessible making it more difficult for Arizona to put forward the trained workforce it needs to attract quality jobs.

No state has cut funding more from higher education since 2008 than Arizona. Per-student funding for Arizona’s public universities is $3,615 less than 2008 levels. Since 2008, average tuition is up by $4,978 at our three public universities.

After a $99 million permanent reduction in fiscal year 2016, the legislature increased university funding in fiscal year 2017 by $32 million. However, $19 million is one-time “additional resources” that is not intended to carry forward into subsequent years. $5 million in ongoing funding is specifically targeted to freedom schools aimed at advancing free-enterprise ideals at Arizona State University and the University of Arizona, while $8.2 million is new ongoing funding to help offset the cost of in-state tuition and student growth. The state currently funds 34 percent of the funding costs for in-state students, significantly below the university system’s desired goal of the state providing 50 percent of the funding costs.
Beginning with fiscal year 2016, Maricopa and Pima community college districts have been written out of Arizona’s statutory funding formula. If funded, these districts would receive $12.8 million. In addition, these two districts have been removed from the formula that provides additional funding for STEM and workforce programs.

The funding cuts and resulting tuition increases have made college less affordable, shifting more of the burden of funding higher education from the state to students and their families, and jeopardizing quality at our post-secondary institutions. Having a highly educated workforce is critical to our economic future, and we need a strong and high-quality higher education system to make that happen.

<table>
<thead>
<tr>
<th>District</th>
<th>Operating State Aid Cuts</th>
<th>STEM/Workforce Program State Aid Cuts*</th>
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<tr>
<td>Maricopa</td>
<td>$6.7 million</td>
<td>$12.2 million</td>
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<tr>
<td>Pima</td>
<td>$6.1 million</td>
<td>$2.9 million</td>
</tr>
<tr>
<td>Pinal</td>
<td>–</td>
<td>$813,000</td>
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* Maricopa and Pima counties were permanently removed from the statutory funding formula.

Source: Joint Legislative Budget Committee staff, Appropriations Report FY 2016.
Do low-income families pay their share of taxes?

Yes. All families in Arizona help pay for health, education, and public safety through state and local taxes. Low-income families pay a larger portion of their income in taxes than do wealthier families.

When all types of state and local taxes are combined—income, sales and property—families with incomes in the bottom fifth pay nearly three times what families in the top 1 percent do—$12.50 for every $100 of income compared to $4.58 for the highest income families and $8.20 for middle income families. Sales taxes make up the largest portion of the taxes paid by those with the lowest incomes. Families with the lowest incomes in Arizona also pay more of their income in state and local taxes than do the lowest income families in California, Colorado, Nevada, New Mexico, and Utah.

Arizona Families with Lowest Incomes Pay a Higher Portion of Their Income in State and Local Taxes than Taxpayers with Higher Income

Families with the lowest incomes in Arizona pay more of their income in state and local taxes than do the lowest income families in neighboring states.

Who doesn’t pay state income taxes?

Surprisingly, corporations and individuals at all income levels can end up paying little or no state income taxes.

Three out of four corporations that filed income taxes in Arizona in 2013 (latest data available) had the minimum tax liability of $50. Fewer than one in ten corporations paid $5,000 or more in income taxes.

Like individual taxpayers, corporations can significantly reduce or entirely eliminate their income tax bill through the use of tax credits. In 2014, corporations reduced their tax liability by $133 million through the use of tax credits and carried another $1 billion over to be used in future years.
Households might pay no state income taxes for one of two reasons:

1. Their incomes fall below $15,000—the threshold set in state law for filing a state income tax return, or
2. They have higher incomes but their tax liability is erased through the use of exemptions, deductions, and tax credits.

For example, a family with income over $50,000 can end up owing no income taxes through common deductions and credits.

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal adjusted gross income</td>
<td>$161,880</td>
</tr>
<tr>
<td>Subtractions</td>
<td></td>
</tr>
<tr>
<td>Standard deduction</td>
<td>-10,173</td>
</tr>
<tr>
<td>Personal exemptions</td>
<td>-6,300</td>
</tr>
<tr>
<td>Dependents (2)</td>
<td>-4,600</td>
</tr>
<tr>
<td><strong>Taxable Income</strong></td>
<td>140,807</td>
</tr>
<tr>
<td><strong>Tax (Income x .0424 less $1,178)</strong></td>
<td>4,773</td>
</tr>
<tr>
<td>Credits</td>
<td></td>
</tr>
<tr>
<td>Student Tuition Organization</td>
<td>-1,090</td>
</tr>
<tr>
<td>Student Tuition Organization — “switcher”</td>
<td>-1,083</td>
</tr>
<tr>
<td>Qualifying charitable organization</td>
<td>-800</td>
</tr>
<tr>
<td>Qualifying Foster Care Charitable</td>
<td>-1,000</td>
</tr>
<tr>
<td>Public schools extracurricular activities</td>
<td>-400</td>
</tr>
<tr>
<td>Military Family Relief fund</td>
<td>-400</td>
</tr>
<tr>
<td><strong>Subtotal — Credits</strong></td>
<td>-4,773</td>
</tr>
<tr>
<td><strong>Taxes Owed</strong></td>
<td>0</td>
</tr>
</tbody>
</table>
Has Arizona Been Cutting Taxes?

Yes. All types of taxes have been cut since 1990. Even when factoring in statutory changes that have increased revenues, tax cuts passed since 1990 will cost the state’s general fund more than $2.2 billion in revenues—more than double that when you adjust for inflation. The tax cuts include:

- Both the corporate and individual income tax rates have been reduced several times at a total cost to the general fund of $1 billion, not adjusted for inflation. Today, the individual income tax rate for the highest income bracket is less than two-thirds of what it was in 1990. The corporate income tax rate is currently in a four-year phase down which, when completed in tax year 2017, will result in the rate being just over half (52 percent) of what it was in 1992.
- 41 individual income tax credits have been adopted, with 33 of them still being in place. The total annual cost of these credits, excluding any carry forward amounts, is approximately $235 million.
- 31 corporate income tax credits have been adopted, with 22 of them still being in effect. The annual cost of these credits, excluding any carry forward amounts, is approximately $133 million.
- New exemptions and increased deductions for all types of taxes amount to $452 million, not adjusted for inflation.
- Allowing multistate corporations to choose their preferred method for determining their taxable income, called single sales factor, means $132 million less per year in state revenues.

Arizona Used to be a High Tax State – But Not Any More

In 1990, Arizona was ranked 10th highest for state and local taxes as a percentage of personal income. Due to the steady stream of tax cuts since then, Arizona ranked 37th as of 2013.

Source: Calculations based on Bureau of the Census and Tax Policy Center data. State and local taxes combined.

How Arizona Compares to Other States

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2013</th>
<th>Number of states with this tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individual Income Tax</td>
<td>38th</td>
<td>41st</td>
<td>43</td>
</tr>
<tr>
<td>Corporate Income Tax</td>
<td>21st</td>
<td>33rd</td>
<td>46</td>
</tr>
<tr>
<td>Property Tax</td>
<td>22nd</td>
<td>31st</td>
<td>50</td>
</tr>
<tr>
<td>General Sales tax</td>
<td>7th</td>
<td>4th</td>
<td>46</td>
</tr>
</tbody>
</table>

Source: Calculations based on Bureau of the Census and Tax Policy Center data. State and local taxes combined.
Between fiscal years 2007 and 2010, state general fund revenues fell by one-third and state spending was cut from $10.1 billion to $7.8 billion. In May 2010, voters approved a temporary 1 cent sales tax that raised approximately $1 billion a year over three years and avoided even deeper spending cuts. For the first time in state history, Arizona ended the 2011 fiscal year with a shortfall—a negative balance of $322 million was carried over into fiscal year 2012. Yet, in 2011 and again in 2012, the legislature and the governor passed major taxes. In both instances, these tax cuts started off with a fairly small impact but included provisions to phase in larger cuts over a six-year period. By fiscal year 2019, the annual impact tax cuts passed during 2011 and 2012 will have increased from $6.7 million to $533.6 million.

**Does cutting taxes stimulate the economy and result in boosting revenues?**

A school of thought exists that tax cuts—particularly those that benefit corporations and wealthy individuals, produce greater economic growth by spurring investment and job creation. In circumstances where taxes make a state noncompetitive, reducing taxes may be warranted. But that is not the case in Arizona. With the exception of the general sales tax, the taxes that Arizonans pay are low compared to other states.

### Delayed Fiscal Impact of Tax Cuts Passed in 2011 and 2012

<table>
<thead>
<tr>
<th>Year</th>
<th>FY 12</th>
<th>FY 13</th>
<th>FY 14</th>
<th>FY 15</th>
<th>FY 16</th>
<th>FY 17</th>
<th>FY 18</th>
<th>FY 19</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>$-6.7</td>
<td>$-21.6</td>
<td>$-61.3</td>
<td>$-205.7</td>
<td>$-257.2</td>
<td>$-408.8</td>
<td>$-517.7</td>
<td>$-533.6</td>
</tr>
</tbody>
</table>

*Source: Joint Legislative Budget Committee Staff, *Tax Handbook 2016*.  

www.AZEconcenter.org  |  January 2017
What would happen if Arizona eliminated the income tax?

State income taxes for individuals and corporations make up nearly half of all revenues to the state general fund. Eliminating these taxes would have a dramatic impact on Arizona families—including a potentially huge loss of state services or huge shifts in taxes from wealthier Arizonans to middle- and lower-income families.

If Arizona were to eliminate the income tax and increase the sales tax to make up for the revenue loss, Arizona’s state sales tax would grow from the current 5.6 percent to about 9.6 percent. Arizona’s sales tax rate would become the highest in the nation, significantly higher than the current top spot of California at 7.5 percent.

Replacing income taxes with sales taxes would also shift tax responsibility away from higher income Arizonans to those earning middle and low incomes. Under this approach, 80 percent of Arizonans would see their state taxes go up, while the richest 20 percent would see a tax cut.

Alternatively, trying to cut spending to make up for the lost income tax revenue would drastically disrupt basic state priorities. Would the legislature simply cut all state agency budgets in half, regardless of the impact? Would the general fund cover just K-12 education and Child Safety with zero funding for prisons, universities, health care, and the Department of Public Safety. Would the group homes and services for people with developmental disabilities be closed? Would the 1.9 million Arizonans who depend on AHCCCS for health care suddenly be without any coverage, disrupting the health care system statewide?

Proponents of eliminating the income tax assert that eliminating the tax will make the state more competitive in attracting new workers and businesses and the resulting economic growth will bring additional revenue to the general fund. However, as supported by the 2016 Alliance Bank CEO Survey, the quality of Arizona’s public education system, our workforce, and infrastructure are far more frequently cited as concerns by the business community than the amount of taxes they pay. Eliminating the 45 percent of state revenues that come from individual and corporate income taxes would mean less revenue for investing in public education, community colleges, universities and infrastructure that are so vital to building a strong workforce and creating jobs.

Individual and Corporate Income Taxes Make Up 45 Percent of State Revenues

Source: Joint Legislative Budget Committee staff, Appropriations Report 2017.
Has Arizona recovered from the recession?

No. While Arizona has recovered the jobs lost during the Great Recession, median family income has dropped by more than $7,000 since 2009 and 25 percent of all Arizona children are living in poverty. The lack of investments in education, infrastructure and other priorities that are needed to lift up the economic opportunities of more Arizonans are a reflection of state revenues and spending that have not returned to pre-recession levels.

Between fiscal years 2007 and 2010, general fund revenues fell by one-third. Voters approved a temporary one-cent sales tax that provided approximately $1 billion a year for three years, avoiding even deeper budget cuts. Ongoing revenues have been slowly increasing since fiscal year 2010 and, by fiscal year 2018, are projected to be slightly higher than their 2007 level.

---

Arizona General Fund Revenues Are Not Expected to Recover Until FY 2018

<table>
<thead>
<tr>
<th>Year</th>
<th>Revenues (Billions of Dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>$9.62</td>
</tr>
<tr>
<td>2008</td>
<td>$8.76</td>
</tr>
<tr>
<td>2009</td>
<td>$6.97</td>
</tr>
<tr>
<td>2010</td>
<td>$6.29</td>
</tr>
<tr>
<td>2011</td>
<td>$8.05</td>
</tr>
<tr>
<td>2012</td>
<td>$8.71</td>
</tr>
<tr>
<td>2013</td>
<td>$9.11</td>
</tr>
<tr>
<td>2014</td>
<td>$8.36</td>
</tr>
<tr>
<td>2015</td>
<td>$8.93</td>
</tr>
<tr>
<td>2016*</td>
<td>$9.22</td>
</tr>
<tr>
<td>2017*</td>
<td>$9.39</td>
</tr>
<tr>
<td>2018*</td>
<td>$9.66</td>
</tr>
<tr>
<td>2019*</td>
<td>$10.03</td>
</tr>
<tr>
<td>2020*</td>
<td>$10.52</td>
</tr>
</tbody>
</table>

* Estimates and Projections
Source: Joint Legislative Budget Committee staff, Finance Advisory Committee Presentation, 10/5/16.
What have been the impacts to state agencies?

Most budget cuts to state agencies have not been restored since the recession. The unrestored state agency budgets combined with one of the nation’s fastest growing populations strains Arizona’s ability to provide the important services its residents expect from their state government to maintain good roads, ample water resources, safe neighborhoods and all of the other services they need to thrive.

The agency that has experienced the biggest reduction in funding is the Department of Revenue. The Department of Revenue is responsible for administering Arizona’s tax laws including collecting much of the revenue that is deposited into the state’s general fund. When the Department of Revenue cuts back on its staff, it impacts all services provided by state government because it generally means there are fewer auditors and tax collectors to collect revenue that is owed to the state. At the beginning of fiscal year 2017, the department laid off 52 staff, many being tax auditors and collectors. In fiscal year 2016, $562 million was collected by the department’s auditors and collectors through the department’s enforcement programs. According to the department, the average collections generated is over $1.5 million for each collector and between $1 and $2 million for each auditor (depending on what type of tax is being audited).
The loss of tax collectors results in less revenue to pay for schools, public safety, infrastructure and other priorities.

Most of the Department of Transportation’s responsibilities are funded by revenue that is separate from the general fund. In recent years, the legislature has swept some of those separate funds to address general fund shortfalls. The Arizona Department of Transportation is responsible for planning, constructing, and maintaining the state’s highway infrastructure. A September 2015 auditor general’s report estimates the state’s transportation system faces a $62 billion shortfall to meet the state’s highway transportation needs over the next 25 years. The auditor general’s report stated that the Department of Transportation needs to spend $260 million on road projects each year in order to maintain the existing system in its current condition, but competing construction needs and priorities make that expenditure unlikely. Consequently, the Department of Transportation reported that it has a backlog of maintenance projects and is falling further behind on maintenance every year. It further reported that as of 2015, driving on roads in need of repair costs Arizona drivers an estimated $1.5 billion annually in extra vehicle repairs and operating costs, according to the American Society of Civil Engineers.

The Department of Transportation relies on the Highway User Revenue Fund and the State Highway Fund for highway construction and other capital projects throughout the state. Revenue for these funds comes primarily from state fuel taxes and motor vehicle registration taxes. In recent years, these two funding sources have been used to backfill general fund dollars in the Department of Public Safety and the Department of Transportation’s Motor Vehicle Division as well as being swept into the general fund, shrinking one of the primary revenue sources that supports the state’s highway infrastructure.
How have the budget trends affected the safety net?

Arizona has a history of bipartisan support for policies that provide temporary help to prevent hunger, homelessness, illness, abuse and neglect. All of these can have lifelong consequences for children and high costs for taxpayers. Budget cuts have weakened the safety net and resulted in expensive emergencies for the state to handle.

Public funding for the safety net works together with private charitable efforts to help struggling families working to get back on their feet—especially families with children. Beginning with fiscal year 2016, no state general fund monies have been appropriated for child care assistance for low-income working families. Only $5.8 million is currently (fiscal year 2017) appropriated for cash assistance, job training and services to address hunger, domestic violence, and homelessness—less than 1 percent of the general fund budget.

Before and during the Great Recession, many budget cuts to the safety net were passed with a short term goal of saving state spending. But the longer term results have been more families in crisis with nowhere to turn for help and expensive emergencies for the state to handle.

An important part of the safety net is welfare for the poorest mothers and children—also known as cash assistance or Temporary Assistance for Needy Families (TANF).

Over the past few years, the monthly cash amount has been cut by 20 percent and the maximum time limit for participation, which was five years until 2009, has been reduced to 12 months, making Arizona the only state with a limit below 21 months. Other qualification rules narrowed eligibility and cut out more than 14,000 children being raised by their grandparents.

The combined result of these policy changes has been dramatic.

At the beginning of welfare reform in 1996, cash assistance was reaching more than half of families with children in poverty in Arizona. Today, fewer than 1 in 13 poor families with children participate in cash assistance.
The Freeze on Child Care Assistance for Low-Income Families Contributed to the Increase in the Number of Reports of Child Neglect

Another part of the safety net, child care assistance for working families, was also cut dramatically. All participating families have time limits on the assistance and all help pay for child care, with copayments based on their income. Parents who don’t have affordable, reliable child care may leave their children home alone or in situations without safe supervision—conditions for child neglect. The evidence shows the loss of child care assistance contributed to the crisis at the Department of Child Safety with a system that couldn’t handle huge growth in reports of child neglect.
Arizona has one of the fastest growing populations in the nation. That means it is even more critical for state lawmakers to make budget and tax decisions with a long-term vision for how those decisions made today will impact the conditions needed in the future to create an economically prosperous state. Arizona must ensure it will have enough schools, roads, public safety, and healthcare to meet the needs of its future residents as well as continuing to manage our scarce water and other natural resources to support the growth. That requires a stable and responsible budget that provides the revenue needed to sufficiently invest in the state’s priorities.

Those long-term policy questions include deciding what to do about Proposition 301 which provides $514 million—in funding annually and expires in 2021 and the recently approved additional funding for Proposition 123 which expires in 2025. Together, these two measures generate more than $745 million in annual revenue for public education and will leave a significant funding gap when they expire.

The manner in which state lawmakers decide to tackle these and other significant challenges will be an important factor in determining whether Arizona can create the economic conditions that will lead to more jobs, higher wages and greater economic opportunities for all of its residents.
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