



**MORRISON INSTITUTE**  
FOR PUBLIC POLICY

# **Restrictions, Mandates, and the Arizona Budget**

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# Restrictions, Mandates, and the Arizona Budget

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## Restrictions, Mandates, and the Arizona Budget

Arizona is emerging from one of the worst state budget crises in the nation. Entering 2003, its projected deficit, measured as a percentage of the general fund, was the fifth largest in the country.<sup>1</sup> The state had slashed spending in 2002 in the face of a \$900 million deficit, but still faced a \$400 million shortfall for fiscal year 2003 and an estimated \$1 billion deficit in fiscal 2004. Although improved revenues have reduced the anticipated gap, fundamental underlying problems remain concerning the ability of lawmakers to control the budget. Some observers consider this a revenue problem, others a spending problem. Our concern in this paper is whether state lawmakers have enough control over either revenue or spending.

Arizona officials concerned with budgeting must live with a variety of financial restrictions. Some are of the “thou shall not” type in regard to borrowing, spending, and revenue raising; others are of the “thou shall” type, requiring spending on particular programs or services. Some, such as the limit on general obligation bond borrowing, stem from long-standing provisions in Arizona’s constitution. Others originated in recent voter-approved measures that require greater spending in certain areas or make it more difficult for the legislature to raise revenues. In addition, recent federal mandates and court decisions have further restricted Arizona lawmakers’ discretion by requiring spending in the areas of health care and school construction. The bottom line, many feel, is that budget makers, especially legislators, have lost considerable power to raise revenues, control the level of spending, and set spending priorities. These serious developments could radically affect Arizona’s future, but their complexity and the complicated connections between the budgets and mandates make them a tough topic for public debate.

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Disputes over financial restrictions and mandates reflect conflicts between people with differing philosophical views concerning the role of government, between direct and representative democracy, among branches of government and among levels of government – battles that all have deep roots in the politics of the state. Broadly, the debate has been: Who should decide? The debate also raises the question of how financial decisions should be made, in particular whether budgeting can be a comprehensive process where everything is “on the table,” subject to the same budgetary mechanism, and participants can measure the value of one alternative against another.

Of particular concern to many observers is the growing role of voters in financial matters. The development is particularly salient in Arizona, because the 1998 *Voter Protection Act* made voters’ decisions on initiative or referendum measures almost impossible for the legislature to alter, no matter how much the measures affect revenues. Voters

adopted the act as Proposition 105, following the legislature's reversal of a previous voter-approved measure reducing the penalty for drug use. The *Voter Protection Act* requires a three-fourths vote in both legislative chambers to make any changes in measures adopted by the voters, no matter what they wind up costing. Moreover, any change must "further the purpose" of the original ballot proposition. All propositions passed in and after 1998 enjoy this protection. Given these barriers, those seeking to change measures adopted by the voters have little alternative but to challenge them in court or to ask voters to reverse or modify their previous decisions.

In this paper we identify the existing types of financial limitations on lawmakers, evaluate their intended and unintended effects, draw comparisons to other states, and explore possible courses of remedial action. We first look at restrictions on debt, spending, and taxing, then at spending mandates. Third, we consider the impact of these on the making of the state general fund budget, which is comprised of revenues from sales, income, and other taxes. Finally, though our main concern is with state government, we note problems at the local level.

## **Limitations on Debt, Spending, and Taxing**

State constitutions and statutes place various types of restrictions on state and local debt, spending, and taxing. Many of these limitations date from the beginning of the twentieth century. Others were prompted by the taxpayers' rebellion sparked in 1978 by voter approval of Proposition 13 in California, a measure that limited property taxation. Proposition 13 led to demands for taxing and spending limits throughout the country.

### **Debt**

When it comes to borrowing, state constitutions and laws impose two general types of restrictions: maximum limits on the amount of debt, and requirements that public referenda be held to permit the issuance of bonds. Debt limits most often apply to borrowing through general obligation bonds, which are paid for out of general revenues backed by the full faith and credit of the issuing government. Limits are often expressed as a percentage (from 15 to 25%) of the value of the property within the jurisdiction, but may also be stated in specific dollar amounts.

Arizona has an unusually low debt limit. Under Article 9, Section 5 of the state constitution, the state may borrow more than \$350,000 only "to repel invasion, suppress insurrection, or defend the state in time of war." This restriction goes back to the original 1910 constitution<sup>7</sup> and applies by court rulings only to general obligation bonds; its effect has been to encourage the state to turn to revenue bonds, which are secured by a specific revenue source such as that generated by a project for which money is borrowed. Revenue bonds usually cost the government more in interest because investors see them as more of a risk than general obligation bonds. Arizona law does not limit the amount the state can raise by revenue bonds, but does require public approval of them. Currently, the state has a debt of some \$5 billion. Debt payments now

take \$71 million out of the general fund, and thus reduce the use of the fund for other purposes. Much of the debt involves long-term financing for items such as school, road, and prison construction. Although the dollar numbers may appear impressive, the latest rankings by the U.S. Bureau of the Census (FY2000) place Arizona 49<sup>th</sup> out of the 50 states in per capita debt outstanding.

Arizona officials, like those in other states, get around both the debt limit and the need for voter approval by issuing certificates of participation (COPs) and entering into complicated lease-purchase agreements. The government leases what it wants — for example, a new building — from a private firm or other third party, then takes title to the building at the end of the lease. Alternately, the state might sell a building to a third party, then put the money in the general fund and lease back the property. In both cases, the lease payments are not considered as debt, but as operating expenses paid for out of annual appropriations. However, as they accumulate, such payments could have a considerable impact on the general fund. While COPs offer flexibility, they are usually more expensive to issue than bonds because of the involvement of third parties.

### **Spending**

A restriction added to the Arizona constitution in 1978 — in response to the taxpayers' rebellion — confines state spending to no more than 7 percent of residents' gross personal income.<sup>2</sup> This percentage may be adjusted to reflect developments such as increased expenditures due to federal mandates or state assumption of local functions. Currently, it stands at 7.41 percent. Spending has thus far never exceeded the limit — as a percent of income it amounted to 5.6 percent in 2004.<sup>3</sup>

Insofar as legislative discretion is concerned, the situation could be far worse. Colorado, for example, limits state government spending to changes in inflation plus population. Colorado's Taxpayers Bill of Rights (TABOR), approved by voters in 1992, also requires that voters approve any new state tax or increase in an existing tax, and that revenues over the amount the state can spend be refunded to taxpayers unless the voters decide otherwise. The law imposes similar restrictions on local governments, limiting local spending to changes in population and property values.

### **Taxing**

A far more effective constraint on the ability of Arizona legislators to adjust to changing needs than the spending limit is Proposition 108, a constitutional amendment adopted by the voters in 1992. This requires a two-thirds majority of the total membership of the House and Senate to increase any tax or revenue source or to make any "net increase" in the state's revenue collection — a requirement that, in effect, makes even the smallest increase very unlikely. Previously, changes of this nature required only a majority vote. This measure has made it much more difficult to raise taxes than to cut them — the latter still requiring only a simple majority. Whether the two-thirds requirement applies to the elimination of tax exemptions — the state has been losing \$4.2 billion a year in sales tax exemptions alone — awaits legal clarification.

Because of the law, the best alternative for those seeking to increase revenues is to take their case directly to the voters. In recent years several groups have done so, asking voters to approve new or increased taxes for particular programs. Legislators, in part because of Proposition 108, have also passed tax decisions on to the voters. It is much easier to secure the legislative votes to put a measure on the ballot – only a majority is required – than it is to round up enough supporters to increase taxes. Indeed, Proposition 108 might be expected to lead to more and more basic tax decisions being made by the voters.

Most states still require a simple majority in the legislature to increase revenues.<sup>4</sup> Arizona is one of 11 states that require a supermajority vote; some of the other 10 impose a three-fourths requirement and some posit three-fifths. Critics charge that supermajority requirements make it difficult for the legislature to respond to emergencies, encourage it to shift costs to local governments – done by a simple majority vote – and may even bring more wasteful state spending.<sup>5</sup> This last result occurs, critics say, because supermajority requirements increase the difficulty of building support for new or expanded taxes, and thus increase the bargaining power of individual legislators. Some lawmakers may be tempted to hold back their support until they can exchange it for leadership support of their own favored projects. There is some evidence of this type of bargaining<sup>6</sup> in California – a state with a two-thirds vote requirement not only for tax increases but for the adoption of the budget and related budget bills. In Arizona the most evident effect of the supermajority requirement has been to take talk of tax hikes through direct legislative action off the table.

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### **Spending Mandates from Voters, Courts, and the Federal Government**

Spending mandates are legal requirements that state lawmakers spend money for certain purposes and certain purposes alone. They take decision-making out of the hands of lawmakers and hinder their ability to plan for or respond to financial emergencies. Not all spending mandates, however, are the same. Some are self-imposed by the legislature and can be changed by altering a statute or evaded through budgetary techniques that divert the flow of existing funds. More difficult to control are mandates imposed by voters (especially those protected by the *Voter Protection Act*), court orders, and the federal government. Voter-approved measures, court decisions, and federal requirements and mandates – particularly pronounced in recent years – have required the state to fund programs and services often without providing the revenues to do so.

## Voters

In recent years, voters have bypassed the legislative process by approving several ballot measures that create a new tax or increase an old one and dedicate the revenues to particular programs. Voters have also approved proposals that require the legislature to pay for new or expanded programs out of general revenues, thereby leaving less money for other programs. Some measures reached the ballot through the efforts of private groups such as health organizations that used the initiative route to take their case to the voters. Often, though, the legislature itself has asked voters to tie its hands by submitting referendums that earmark funds beyond legislative control or commit the legislature to spend large amounts of money out of general revenues.

In 1994, for example, a coalition of health organizations persuaded Arizona voters to raise tobacco taxes and dedicate the proceeds to a variety of health care programs, beyond the reach of the legislature. Later, however, the coalition became unhappy over the legislature's raiding of the tobacco fund for purposes other than those for which it was intended. The group contemplated asking voters to approve a similar but expanded plan that, because of the *Voter Protection Act*, would be out of the reach of the legislature. Lawmakers headed this off by developing a proposal acceptable to the group and submitting it to the voters in a referendum. Voters went along with the second tax hike on tobacco in 2002, the proceeds of which are earmarked for particular programs. On the plus side, the shifting of support for some existing programs to tobacco taxes saved the general fund budget an estimated \$63 million in the first year alone. On the minus side, the programs slipped out of the control of the legislature. Voters in 2002 also supported an Indian gaming measure that several tribes had negotiated with Governor Jane Hull, but which the governor could not get through the legislature. Taking the initiative route, the tribes won voter approval of a new gaming compact under which tribes will share 8 percent of their gaming revenues with the state. These funds are earmarked for a variety of specific purposes, such as reducing school class sizes, wildlife conservation, and health care. This is expected to generate \$54 million for fiscal 2004 and over \$80 million for fiscal 2005.

The two voter-approved measures that have thus far made the largest impact on the general fund were adopted in 2000, making them tamper-proof by the legislature. One was Proposition 204, which expanded eligibility for benefits from the Arizona Health Care Cost Containment System (AHCCCS, the state's Medicaid alternative) to all residents at or below the poverty level; eligibility had previously extended up to about 35 percent of the poverty level. The proposition added thousands more Arizonans to the program and increased costs by hundreds of thousands, but provided only some \$80 million per year from the state's share of the nationwide tobacco lawsuit settlement. This, as it turned out, was not enough. The legislature in 2003 was left with the problem of finding additional millions in the general fund to finance the program's growth. The second measure, Proposition 301, increased the sales tax to 5.6 percent from 5 percent for 20 years to fund the public education system and earmarked the funds so that they were not subject to legislative appropriation. Proposition 301 was developed by Governor Hull and put on the ballot by the legislature after it was unable to come up with the two-thirds

vote required by Proposition 108. The measure created a dedicated revenue stream of some \$440 million in new funds, much of it for teacher pay raises. The measure also required the legislature to increase the base level of state aid to K-12 education by \$94.5 million in 2002 and to adjust it annually by 2 percent or the inflation rate, whichever was less. These expenses were to come out of general revenues.

## Courts

Both state and federal courts have deeply impacted state budget-making around the country. State courts in general have become more active since the 1980s in reviewing the decisions of elected officials and administrators. One reason for this is that the U.S. Supreme Court has encouraged the resolution of issues in state courts under state law. In addition, various groups have found that litigation in state courts, while expensive, is much less costly than intensive lobbying in the legislature and administrative areas and is also likely to be more successful. As a result, state courts have become more actively involved in making general policies governing the operation of schools, prisons, and other public institutions. With this increased activity, they have antagonized more groups and have often provoked negative reactions.

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The Arizona Supreme Court historically has not been among the most active courts when it comes to finding state laws in violation of the state constitution or in expanding state constitutional rights.<sup>7</sup> But it has made some important decisions that have forced changes in the state's spending priorities. A prominent example occurred in 1994 when the state Supreme Court ruled, in response to a 1991 suit by the Arizona Center for Law in the Public Interest, that the legislature must reduce gross disparities among school districts concerning the conditions of school buildings, equipment, and other capital needs.<sup>8</sup> The court, in a 3-2 decision, found that such disparities violated the state constitutional requirement for a general and uniform public school system. The court ordered the legislature to fix the system "within a reasonable time." Over the next 4 years, the court rejected several legislative proposals to remedy the problem until, in 1998, it threatened to end all public school financing unless the legislature corrected the inequities.

In that same year, the legislature came up with acceptable legislation, called "Students First," which assigned the state most of the responsibility for school construction and maintenance — moving the expense of some \$2 billion from local property taxes to the state. To pay for it, the legislature used revenue bonds, lease-purchase schemes, and general revenues, the latter mostly to pay off the debt. Since then, however, an almost continuous stream of litigation has claimed that the program's building-renewal fund, which provides school districts money to make repairs, has not been properly funded and has been illegally raided by the legislature to cover budget deficits. The legislature used \$69 million from the Student's First building-renewal fund to help balance the

fiscal 2002 budget, and, despite a court ruling to the contrary, \$90 million to balance the 2003 budget. For fiscal 2004, it decided to temporarily stop putting money into the fund.

The Arizona courts' struggle with the legislature over Students First was nothing compared to their decades-long effort to compel the legislature to live up to its agreement to improve funding for mental health services. The principal case, *Arnold v. Sarn*,<sup>9</sup> was begun in 1981 and was resolved as far as the legal issues were concerned in 1989. But only in recent years have any funds been forthcoming.

The courts have also produced results in regard to class action tax litigation. In 2001, the state Supreme Court made it easier for taxpayers to band together and file class action lawsuits challenging tax laws and decisions; the court did so by ruling that plaintiffs do not have to first individually exhaust available administrative remedies.<sup>10</sup> In 2002, the state lost a class-action lawsuit regarding the taxation of dividends from out-of-state corporations<sup>11</sup>; in 2004 it must begin refunding \$350 million in taxes. Governor Janet Napolitano has sought, thus far without success in the legislature, to prohibit or at least slow down such suits. Also pending is a suit by 140,000 public employees who claim they were illegally taxed by the state.

In passing, one should note that Arizona has recently had some difficulty with federal as well state courts. A costly example was the 2000 *Flores v. Arizona* decision by a federal district judge, who ruled that the state's underfunding of language-acquisition programs in Arizona public schools violated the federal *Equal Education Opportunities Act*.<sup>12</sup> In fiscal year 2003, the state spent \$44 million to comply with the decision.

### **Federal Government**

In the mid-1970s, the federal government, faced with budgetary problems of its own, began using regulatory mandates rather than subsidies to encourage states and localities to take various courses of action. These laws compel state and local governments to comply with certain policies — and thus often to absorb various costs — under the threat of civil and criminal penalties. Costly federal mandates have been enacted in areas such as air and water quality, solid waste, hazardous waste, transportation standards, labor management, health care, courts, and corrections. Specific examples of congressional legislation creating unfunded mandates are the *Americans with Disabilities Act*, *Safe Drinking Water Act*, and *National Voter Registration Act*. Mandating allows federal officials both to claim credit for acting on a variety of issues and, by shifting much of the costs onto state and local governments, to reduce pressures on the federal budget. As a National Governors Association official put it: “The idea is that they get the credit, we get the bills.”<sup>13</sup> Faced with growing discontent among local officials, Congress in 1995 passed the *Unfunded Mandates Reform Act*, which was intended to make federal mandating more difficult. Although the act appears to have focused greater congressional attention on the issue, state and local officials continue to complain about expensive federal directives.

Researchers also commonly categorize expenses associated with federal grants, such as state matching requirements, as mandated spending. One can argue that this is an inaccurate designation, because states are not forced to take federal aid and, therefore, come up with matching grants. In practical terms, however, states have found it difficult to turn away federal funds. And once tied into a federal program, they find it difficult both politically and financially to give it up. But being linked in this manner means that state budgets are significantly impacted by not only requirements for matching funds but also by federal changes in service level requirements; state lawmakers also often feel compelled to fill in for cuts in federal spending. Arizona is perhaps most importantly tied into federal policy making through the joint federal-state Medicaid program, which provides health coverage to the poor. Federal funds make up about two-thirds of the \$3.5 billion AHCCCS budget. The state spends over \$600 million each year on the program out of general funds, mostly in matching grants.

State and local governments are subject to regulations and controls that come as a condition of accepting federal aid. All grants, for example, are subject to certain crosscutting requirements, such as one that bars the use of federal funds to support programs that discriminate against racial minorities. In other situations, state and local governments have been subject to crossover sanctions. These can curtail federal aid to state and local governments unless they adopt policies that are related only indirectly, if at all, to the aid program in question. Congress, for example, has threatened to withhold federal highway funds unless states adopt a 55-mile-per-hour speed limit, raise the drinking age to 21, and, most recently, modify DUI laws. Any costs involved have been absorbed by the states.

One recent federal measure with an expensive impact on state budgets is the *No Child Left Behind* law that took effect in January 2002. The statute was designed to improve overall academic performance and to end chronic gaps in achievement among students in different districts and between disadvantaged and more-advantaged students. It puts considerable pressure on states to design and implement standardized testing programs, and on local school systems to improve achievement across the board — or face consequences ranging from having to pay for private tutoring to having the state take over their schools. The program may well cost Arizona more than \$100 million just to comply with the testing requirements. Other costs include those for data collection, developing higher teacher and curriculum standards, and upgrading tutoring and reading programs. If Arizona chooses to ignore the law, however, it could lose over \$300 million annually in federal funds for financially needy students. In another example, Arizona lawmakers have long complained about federal laws that require state and local governments, particularly along the Mexican border, to pick up some or all of the costs of health and educational services for both legal and illegal Mexican immigrants.

## Controlling the Budget

In Arizona as in most other states, most of the public’s attention concerning state financial matters centers on legislative, gubernatorial, and agency activity in the making of the general fund budget, which is based on revenues from sales, income, and other taxes. But while this exercise features a balancing act that requires a great deal of fund shifting and imaginative accounting – especially in times of economic stress – it directly accounts for only a portion of what the state spends each year. Though legislators have more influence over spending than is commonly assumed, much spending is mandatory. The budgeting process, moreover, falls far short in terms of comprehensiveness or thoroughness.

### The Big Picture

In recent years, the general fund budget has accounted for less than half of what the state spends annually. In FY 2003, for example, the general fund portion was 38 percent. The remainder consisted of: federal funds, the spending of which is largely controlled by the governor and agency heads, some 28 percent; and funds built up from fees or from earmarked taxes for particular programs, 34 percent. Examples of the latter include the earmarking of motor fuel and highway user taxes for transportation purposes and, as already noted, of tobacco taxes for health programs. At last count, there were 270 non-appropriated special and revolving accounts.

Arizona Total Operating Budget – FY 2003

	Amount (\$ billions)	%
General Fund	6.2	38
Earmarked Fees and Taxes	5.6	34
Federal Funds	4.7	28
<b>Total Budget</b>	<b>16.4*</b>	<b>100</b>
General Funds – Non-Discretionary	3.9	24
General Funds – Discretionary	2.3	14

\*Budget figures may not total \$16.4 due to rounding.  
Source: Joint Legislative Budget Committee.

Approximately 60 percent of state spending takes place outside the general fund. Within the general fund, moreover, another 60 percent is essentially non-discretionary, in that it is automatically programmed to increase or decrease according to formulas in the laws creating various programs.<sup>14</sup> Much of the growth in the general fund budget in recent years has come because of formulas calling for increased spending as the number of school children increase or as more people go on AHCCCS. It is in these areas where voter-approved spending measures – Propositions 204 and 301 and Students First – have had their greatest impact in terms of both increasing expenditures and limiting legislative discretion.

Overall, the picture appears dismal when it comes to legislative control of spending. In fiscal year 2003, for example, Arizona had a total operating budget of \$16.4 billion and a general fund budget of \$6.2 billion. But within the general fund budget, lawmakers

could be said to have had discretionary control of just \$2.3 billion — or some 14 percent of the overall total. On the other hand, the situation is not so dire in practice because the legislature, by changing or suspending statutes, can tap into off-budget funds to balance the general fund budget. It also can change the formulas driving general fund spending — though not those approved by the voters in recent years.

### The Process

In Arizona, as in all other states except Vermont, the general fund budget must be balanced each year.<sup>15</sup> The adoption of the budget requires a majority vote of the entire membership — 31 house members and 16 senators. A few other states invite stalemate and lengthier sessions by imposing a greater hurdle — a three-fourths vote in Arkansas and a two-thirds vote in California and Rhode Island. In terms of decision-making, the Arizona budget process, like that in Colorado, often takes the form of “a succession of responses to revenue forecasts.”<sup>16</sup>

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In Arizona, dueling revenue projections typically come from the governor and the legislature. The size of the deficit, if any, is usually a matter of some dispute. When there is consensus that revenues are likely to lag behind a desired level of expenditures, the budget is “balanced” through a variety of moves: borrowing money, selling state property (with or without lease-back provisions), making transfers into the general fund from other state funds, shifting expenses to federal programs, and performing various sleight-of-hand accounting moves such as counting revenues not yet received or postponing payment of bills to the next fiscal year. An example of the latter is the education “rollover,” through which the legislature postpones payments to schools from one fiscal year to the next to make the budget appear balanced. Sometimes legislators have been lucky: In 2003, for example, Arizona was able to create a budget for fiscal 2004 without tax increases or major cuts with the aid of a one-time federal bailout of \$308 million.

Even earmarked funds are not all that secure. In 2003, for example, the legislature sliced the share of the state income tax earmarked for municipalities from 15 percent to 14.8 percent, and diverted some highway fund money going to localities into the general fund. Still, when cuts must be made, attention is likely to be first drawn to the most vulnerable of the programs supported by general revenues. In 2003, much of the money controlled by the legislature went to the Department of Corrections. Cutting this budget, however, was politically off limits. The number of prisoners had been steadily rising because of population growth and because of get-tough measures adopted by the legislature that increased both the number of people sent to prison and the length of time served. But few lawmakers seemed willing to reduce costs through early release programs that would put convicts, even those not considered dangerous, back on the streets. In the end, the most vulnerable funds were those for the university system and some non-protected spending for K-12 education and other social services.

Somehow, the budget gets balanced. But the process is far from ideal when it comes to making a comprehensive evaluation of the state’s spending programs. Lawmakers periodically express concern that so little of what Arizona spends is directly subject to legislative review through the general fund appropriations process. Some have proposed “Truth-In-Budgeting” acts that would bring federal dollars and various agency funds into the appropriation process. Governors, who control many of the funds through their agency directors, have successfully resisted such proposals. It has not been a partisan issue. In 2003, Democratic Governor Napolitano vetoed such a measure passed by the Republican legislature. In 1996, an earlier Republican legislature passed a similar act, only to have it vetoed by Republican Governor Fife Symington.

Even legislators themselves have not been altogether willing to abandon the idea of earmarking funds and keeping them out of the general fund appropriation process. In part, this is because individual members are uneasy about what their colleagues might do to particular earmarked programs if they had to compete for funding. In 1994, for example, lawmakers resolved to bring several non-appropriated funds under legislative control. The following year, however, they wound up agreeing that funds for several favored programs — notably the Arizona Commission on the Arts — should stay earmarked to ensure that they were not “zeroed out” and appropriated for other purposes.

### **The Earmarking Problem**

Arizona has been considerably above the national average for earmarking. State officials have been earmarking about 31 percent of revenues in recent years, while the national average for states has been about 22 percent.<sup>17</sup> Much of the earmarking is self-imposed by the legislature; lawmakers could change the statutes, but are reluctant to do so because of pressure from affected groups and because of their commitment to particular programs.

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Earmarking has value in providing a relatively secure and stable source of funding for a program or activity. In the case of motor fuel taxes, it reflects the idea that those who benefit from how tax monies are used (highway users) should pay the taxes. In a practical sense earmarking is also useful in helping secure voter support for new or increased taxes — taxes are more acceptable when tied to a popular program or cause, such as education reform. On the negative side, the practice gets in the way of comprehensive budgeting — where, ideally, legislators weigh all funding proposals against each other — and makes it more difficult for lawmakers to adapt to changing social and economic conditions. The lack of flexibility may be particularly harmful in regard to the highway fund. Placing gasoline taxes in the highway fund guarantees a certain level of support for road building and maintenance. But the practice ties up a great deal of revenue and thus limits lawmakers’ ability to respond to other pressing problems.

Finally, by removing programs and services from the periodic review of the appropriations process, earmarking slants state governmental activities in favor of priorities that the legislature fails to reexamine or weigh against new concerns. Conversely, programs not protected by the practice become more vulnerable to budget cuts when conditions are tough.

## **The Situation for Local Governments**

General purpose local governments — counties and municipalities (cities and towns) — share many of the problems of the state government when it comes to limitations on their ability to raise and spend funds, though an overall assessment of their impact on local budgets has yet to be made. Many of the restrictions have to do with the property tax which, in Arizona, is almost exclusively a local tax. In addition to restrictions on borrowing, spending, and taxing, local budgeting is impacted by mandates coming not only from the usual suspects — voters, courts, and the federal government — but from the state government as well.

### **General Limitations**

Constitutional provisions and state statutes impose controls on nearly all aspects of local financial management: assessment, taxation, indebtedness, budgeting, accounting, auditing, and fiscal reporting. State law also places various restrictions on borrowing — limits are expressed as a percentage of the assessed property value in a jurisdiction; localities cannot exceed these limits without public approval. On the whole, however, local governments are freer to borrow money than the state, and in the aggregate do about three times as much. As for spending, a 1980 amendment to the Arizona constitution limits local government expenditures to the levels that existed in FY1979, as adjusted annually to reflect changes in population and the cost of living. The law exempts certain expenditures, such as for bond principal and interest payments. Spending in excess of the limits must receive a two-thirds vote of the governing body, as well as voter approval. In practice, this formula has had an adverse effect on municipalities that have experienced rapid growth since 1980 and the accompanying need for greatly increased infrastructure and other expenditures. However, cities and towns can seek voter approval to adopt an alternative way of setting the expenditure limit by, for example, making a permanent base adjustment based on current spending. Approximately half of Arizona’s cities and towns have persuaded voters to approve alternative systems. Whatever choice they make, every city and town must comply with a uniform state reporting system and file an annual report showing its compliance with either the state or local expenditure limit.

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## **Property Taxes**

The taxpayers' revolt also spawned provisions added to the state constitution in the late 1970s limiting increases in property tax rates, property assessments, and overall property tax levies. The limits apply to the primary property tax, which is used to support general governmental operations. The secondary property tax, drawn upon for bond issues and other specific purposes, is not subject to these limits.

Under the Arizona constitution, increases in the value of the property drawn upon to fund local government operations are limited, generally to 10 percent each year. In addition, the total amount of taxes drawn on such property by counties, cities, and community college districts can grow by no more than 2 percent from one year to the next, plus an amount concomitant with new construction. However, local governments may approve property revenue increases in excess of these limits through override elections.<sup>18</sup> An additional restriction in state law limits the primary property taxes homeowners must pay to all local jurisdictions to a combined 1 percent of the value of their residence. Still another restriction is a "Truth-in-Taxation" law that requires local governments to roll back primary property tax rates to reflect increases in assessed valuation and provide public notice before voting to increase a rolled-back rate.

Restrictions on property taxes have made life a bit more difficult for local decision-makers. The restrictions, plus the unpopularity of the local property tax, have encouraged local governments to turn away from this source and use less restricted revenue sources, particularly fees and sales taxes.

## **Mandates**

When faced with budgetary problems, state officials have looked favorably upon imposing mandates on local governments — both by passing along federal mandates and by enacting their own. Local governments, at the end of the path of "one-way federalism" — or what some call "shift and shaft federalism" — wind up paying many of the costs of government. In Arizona, county officials in particular have objected to costly mandates in the area of health care, and to the propensity of state officials to dump "the ugly jobs" on them. In the FY 2004 budget alone, counties absorbed a \$55 million hit, picking up state responsibilities for several functions. According to the best estimates, 80 percent of the expenditures of the average county are mandated. Municipalities enjoy a more independent status vis-a-vis the state and are not as heavily impacted by mandates. Even when local officials sympathize with the goals of state mandates, they are aware that all mandates distort local priorities, restrict local managerial flexibility, and impose costs that have to be paid through local revenues.<sup>19</sup>

Arizona, like many other states, has a fiscal note process that is intended to call attention to the costs imposed on localities by unfunded state mandates. In Arizona, fiscal notes are prepared by the Joint Legislative Budget Committee at the request of a member of the legislature. Local officials, however, complain that reliable cost estimates have not been produced at all or have been done too late to influence legislative

decision-making, and have called for a strengthening of the process. Several states, but not Arizona, combine fiscal notes with a constitutional or statutory requirement that the state reimburse localities, in full or in part, for the expense of undertaking the mandated activity. As a deterrent to unfunded mandates, a requirement for reimbursement is more effective than a simple requirement for cost estimates.<sup>20</sup>

## Conclusions and Recommendations

The impact of restrictions and mandates may not be unusually severe in Arizona as compared to California or Colorado, but they do present certain governing problems. On the surface, governors and legislators have lost considerable control over the budget because of formula-driven expenditures, largely for education and health care, mandated by the voters. The recent decline in general revenues has made finding discretionary money in the general fund particularly difficult. All other things being equal, the problem will lessen as the economy improves, or if the state can somehow tap into new general revenue sources. At the same time, one should not discount the amount of control or potential control lawmakers have over budgetary matters even when the economy goes sour. By changing a few statutes or implementing some budgetary techniques, they have access to several funds built up from earmarked taxes and user fees. Governors and legislators have been remarkably agile in balancing the budget without either making major spending cuts or tax increases. Overall, though, there are areas where more general flexibility is needed, particularly in regard to borrowing money and raising taxes. There is also a more profound need to move toward a more comprehensive general budgeting process in which lawmakers can more sensibly weigh the relative merits of programs and proposals and balance spending and revenues.

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Arizona elected officials have always been a bit ornery where the federal government is concerned, and have taken complaints about the federal mandates and related matters to Washington; they have voiced them directly or funneled them through national organizations and the congressional delegation. Arizona governors and legislators have also often been at odds with judges because of court rulings on mandates and other questions. However, the legislature, if often grudgingly, has had to somehow adjust the budget to courts' demands for increased spending. Still, the legislature is not altogether powerless. It can, for example, change laws dealing with class action lawsuits in tax cases. More generally, it can minimize the possibility of lawsuits by living up to its obligations — for example, by properly funding programs to which people are entitled by law.

The initiative process has enjoyed increasing use in recent years. In the 1980s, groups initiated a total of 63 statewide initiative drives. In the 1990s, this swelled to 155; 30 more were begun in 2000 and 2002.<sup>21</sup> Less than 20 percent of these have made it to

the ballot and, of those, only about half were approved. Still, voters have had a significant impact on Arizona's financial well being through the initiative process. They have approved the creation and extension of the state lottery, increased tobacco taxes for health care, and expanded eligibility for health care. Voters using the initiative process also limited the ability of state legislators to raise taxes.<sup>22</sup> In addition, voters have had to decide the fate of proposals placed on the ballot by the legislature. In fact, the number of financial measures on the ballot will likely increase, as Proposition 108 encourages advocates to take their case for a tax increase to the voters.

While there may be good practical reasons to turn to the voters, what is known as "ballot box budgeting" is something of a nightmare. It involves making major program choices and funding policies one at a time, in a vacuum, without consideration of how they relate to other policy alternatives, overall priorities, or their impact on revenues. Indeed, opposing groups have both placed their cases before Arizona voters — one side asking them to make raising taxes more difficult and the other asking them to spend more on government programs — and the voters have given both sides what they wanted.

The *Voter Protection Act* requires those who are unhappy with particular voter-approved measures to take their case back to the voters for modification or repeal. To guard against making mistakes in the first place, some groups have called for a constitutional change prohibiting a ballot measure from going into effect unless it is approved by the voters in two consecutive elections. To reappraise ballot measures over time, some have advocated that the constitution be amended to require that ballot measures be reauthorized on a periodic basis, such as 5 or 8 years. Others — particularly those concerned about unwise and excessive spending — have called for making the adoption of ballot measures dependent on a two-thirds vote.

To protect against budget problems that have surfaced with some ballot measures, particularly Proposition 204, a good idea would be to require that all initiative or referendum measures mandating spending also identify a source of revenue for that spending and, if the source proves to be insufficient, allow the legislature to reduce expenditures to the amount of funding actually supplied. A measure along this line will appear on the November 2004 ballot. In addition, to increase legislative flexibility in raising revenues and possibly reduce the need for voter action, Proposition 108 should be repealed, returning the requirement for the approval of tax measures in the legislature to a majority vote. The state also could benefit by amending the constitution when it comes to debt. That is because the limitation on general obligation bond borrowing has not only reduced legislative flexibility but also has encouraged it to turn to more expensive and complicated methods of borrowing money. Finally, for local governments, there may be a need for a more effective fiscal note system and, perhaps, one backed by a constitutional provision requiring reimbursement.

## Notes

1. Public Finance in Arizona, Report prepared by Center For Business Research, L. William Seidman Research Institute, College of Business, Arizona State University, January 2003 p.23.
2. Arizona Constitution, Article 9, Section 17.
3. Joint Legislative Budget Committee, "State Appropriations Limit," February 16, 2004.
4. National Conference of State Legislatures, "Supermajority Requirements to Raise Taxes," 2003.
5. See commentary in Voters Check This Out, pamphlet compiled by the Arizona Secretary of State for General Election, November 3, 1992, pp. 54-55.
6. California Citizens Budget Commission, A 21st Century Budget for California: Recommendations of the California Citizens Budget Commission (Los Angeles, Center for Governmental Studies, 1998), p.3.
7. Susan P. Feno, *The Role of State Supreme Courts in the New Judicial Federalism* (Westport, Conn.: Greenwood Press, 1987) .
8. *Roosevelt Elementary School District No. 66 v. Bishop*, 179 Ariz. 233, 877 P. 2nd 806, (1994).
9. 775 P. 2nd 521 (Ariz. 1989).
10. *Arizona Department of Revenue v. Dougherty*, 200 Ariz. 515, 29 P.3d 862, (2001).
11. For background on the litigation on a complaint filed by Helen H. Ladwig see *Arizona Department of Revenue v. Dougherty*, *Ibid*.
12. *Flores v. Arizona*, United States District Court for the District of Arizona, 160 F.Supp. 2nd 1043 (2000).
13. Quoted by Neal Peirce, "Angry States Left with Tab for Social Services," *Washington Post syndication*, August 1989.
14. It is mandatory spending in the sense that it cannot be changed without changing a statute. See: Joint Legislative Budget Committee Staff Memorandum, "Mandatory vs. Discretionary Spending," from Jennifer Vermeer, Assistant Director to Richard Stavneak, Director, October 8, 2002.
15. Arizona Constitution, Article 9, Section 3.
16. Scott Moore, "Budgeting in Colorado: The Unspoken Crisis in 2003," paper delivered at the 2003 Conference of the Western Political Science Association, p.3.
17. *Dedicated State Tax Revenues: A Fifty-State Report* (Bethesda Maryland, Fiscal Planning Services, June 12, 2000. This study uses financial information from the 1954 to 1997.
18. Details on these restrictions are found in An Explanation of Arizona Property Taxes, Arizona News Service, Inc. and The Arizona Tax Research Foundation, 2003.
19. As an alternative or supplement to shifting costs to local governments, the state sometimes takes away revenues it has been giving to local governments, for example, reduces the local portion of a shared tax, or takes over funds collected by local governments and uses them to support state programs.
20. See: David R. Berman, A"State-Local Relations: Authority, Finances, Cooperation," *The Municipal Year Book 2002* (Washington: The International City/County Management Association, 2003) 45-61.
21. "Initiative Drives Since 1970," *Arizona Capitol Times*, 5 September 2003, p. 12.
22. One initiative proposed in 2000 that did not make it to the ballot, to the relief of many public officials, would have phased out the state's corporate and individual income taxes — at the time the state was collecting \$2.6 billion a year in income taxes. The measure was taken off the ballot after state courts found that it failed to conform to the single subject requirement of the state constitution. See: *Taxpayer Protection Alliance v. Arizonans Against Unfair Tax Schemes*, Arizona Supreme Court, No. CV-00-0300-AP/EL.