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- Preliminary Draft -

INTERGOVERNMENTAL FISCAL RELATIONS IN ARIZONA

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INTERGOVERNMENTAL FISCAL RELATIONS IN ARIZONA Executive Summary

The Arizona fiscal system consists of counties, cities, school districts, and special districts in addition to the state government. The existence of these local jurisdictions provides a range of options for citizen choice and enhances the efficiency of governmental units by fostering competition between them.

Counties

Arizona counties do not have home rule authority so their duties and powers must be prescribed by state law. The counties rely on state aid, user fees, property taxes, and franchise taxes to carry out state mandates in areas such as public health, law enforcement, and indigent health care. The counties spend a greater portion of their funds on social services than on any other major service category. To finance their activities, Arizona counties rely more heavily on service charges and less heavily on non-property taxes than counties in the U.S. aggregate.

Municipalities

Arizona cities and towns operate under general law or home rule charter. They rely on service charges, state aid, sales and use taxes, business license and franchise taxes, and property taxes to provide services such as police and fire protection, planning and zoning, parks and recreation, and garbage collection. Arizona cities rely more heavily on sales taxes and service charges than municipalities in the U.S. aggregate.

School Districts

School districts in Arizona rely heavily on state aid and property taxes to finance education expenditures. In total, they expend more funds than any other type of local government.

Special Districts

Special districts are limited purpose governmental units authorized by state law for specific service provision and revenue-raising activities. In aggregate, special districts in Arizona spend approximately three quarters of their funds on natural resources and sewers, and rely on user charges and fees for approximately 80 percent of their total revenue.

Revenue and Expenditure Limits

In 1978 and 1980, Arizona established a series of constitutional and statutory revenue and expenditure limits which apply to the state government and local jurisdictions. Due to several limits relating specifically to property taxes, local governments

reduced their reliance on property tax revenue between 1977 and 1987, and increased their reliance on user fees and service charges. Because special districts fall outside the local government revenue and expenditure limits, they are a vehicle for providing new or enhanced public services without further straining city and county budgets.

State Aid

State aid to local governments can serve to equalize tax burdens and/or service levels between jurisdictions, and to increase those local government goods and services that create statewide benefits. The nature of state aid varies significantly from state to state. State aid in Arizona establishes strong fiscal linkages between the state and local governments through the sharing of state tax revenues and the appropriation of state funds to school districts. In 1987, Arizona cities, counties, and school districts depended on state aid for 25 to 50 percent of their total general revenue. Also in 1987, the state of Arizona distributed 41 percent of its total general revenue to local governments compared to an aggregate U.S. state distribution of 33 percent.

In summary, the Arizona state shares of both total state and local revenue and expenditures in FY 1987 were below the state shares of the U.S. total, indicating that the Arizona fiscal system is relatively decentralized. Because of the fiscal relationships between the state and local governments, changes to the state fiscal system cannot be thoroughly evaluated without examining potential impacts on local government operations.

INTERGOVERNMENTAL FISCAL RELATIONS IN ARIZONA

The Arizona fiscal system involves not only the state government, but numerous units and types of local governments as well. There are several reasons why local governments exist in our national political system.

First, citizens differ in their preferences for the types and levels of public services provided. If there were just a state government with no local subdivisions, citizens could express their preferences through voting, but they would have to live with a single package of services. With the existence of local governments, however, citizens can express their preferences by moving to a locality that offers a preferred service package.

Second, the existence of numerous subdivisions of local government fosters competition between governments and, thus, helps to enhance the effectiveness and efficiency of each governmental unit. If elected officials and government managers know that citizens and businesses can choose to move to another jurisdiction, they will be more motivated to respond to citizen desires and to "produce" a quality government product.

Third, the existence of local subdivisions allows different governments to experiment with innovative policies and enables governments to learn from the successes and failures of other jurisdictions. As Supreme Court Justice Brandeis once observed, "It is one of the happy incidents of the Federal system that a single courageous state may, if its citizens choose, serve as a

laboratory, and try moral, social, and economic experiments without risk to the rest of the country."

Of course, there are also several disadvantages to a decentralized governmental system. Since many governmental services have effects--both positive and negative--on citizens in other jurisdictions, the political decisions of an individual jurisdiction may be inefficient from an overall perspective. A particular town, for example, may choose not to invest funds in a modern sewage treatment plant because it can ship its waste down river. Of course the waste is imposing environmental and health costs to citizens down river, but since the first town does not take account of these outside effects when making its decisions, it does not choose the efficient method of waste disposal.

A second disadvantage of a decentralized system is the loss of economies of scale. Numerous individual jurisdictions may be duplicating administrative costs of providing services and collecting taxes.

In addition, local units of government are not as able to implement policies that redistribute resources from wealthier citizens to less wealthy citizens. Because people can move between jurisdictions, a local redistribution policy would provide incentives for wealthier citizens to move elsewhere and for less wealthy citizens to migrate to the jurisdiction. Thus, a local government may not be able to maintain a balanced population and may be prevented from implementing redistributive programs.

Because there are advantages to decentralized governments and also advantages to a centralized system, a complex intergovernmental, overlapping system has evolved. The major units of subnational government in the United States are states, counties, municipalities, school districts, and special districts. Each has different service responsibilities, different taxing authority, and different legal and organizational constraints. Local governments are creations of the states and their characteristics vary significantly from state to state.

LOCAL GOVERNMENTS IN ARIZONA

Table 1 shows the number and kinds of local governments in Arizona.

TABLE 1

Types of Governments in Arizona

	<u>1977</u>	<u>1987</u>
State	1	1
Counties	14	15
Cities and Towns	70	81
School Districts	230	227
Special Districts	106	253
TOTAL	421	577

Source: Governmental Organization, Census of Governments, U. S. Department of Commerce, Bureau of the Census, selected years.

Compared to other states, Arizona has relatively few units of local government. In 1987 the numbers of local governments

ranged from 18 in Hawaii to 6,627 in Illinois. In 1982, Arizona had fewer local governments than forty other states. Municipalities in Arizona (in 1982) made up a much lower percentage of the total number of local governments than they did in the U.S. as a whole, while Arizona school districts made up a much higher percentage. While the number of Arizona governments grew by 37 percent between 1977 and 1987, the total number of local governments in the U.S. more than doubled.

All units of government within a state are interrelated and one of the chief forms of interaction between them is fiscal. This report examines the fiscal relationships among Arizona's state and local governments--their various service responsibilities and sources of funding.

Counties

Arizona counties are primarily administrative arms of the State. The County Boards of Supervisors are elected policy-makers who must work with other elected officials in order to govern (i.e. county sheriffs, assessors, and attorneys). The counties do not have a home rule option so they cannot create their own charters defining their responsibilities. Rather, the State Constitution requires that the duties and powers of the counties be prescribed by state law. Accordingly, services provided by Arizona counties must either be mandated or authorized by state statute. The primary role of the counties, then, is to serve as subdivisions of state government, carrying

out state-mandated functions. Major categories of services mandated for the counties include:

- * air pollution control
- * indigent health care
- * public health
- * transportation
- * solid waste management
- * planning and zoning
- * recording of deeds
- * property tax collection
- * administration of elections
- * voter registration
- * law enforcement
- * maintenance of justice and superior courts
- * assessment and appraisal of property

County revenue sources to finance these services are fairly limited. Counties cannot impose sales or income taxes; they rely on property taxes, franchise taxes, user fees and charges, and intergovernmental revenues. (Counties can levy, by a vote of the people, a special sales tax for transportation expenditures. This funding is transferred to the state and/or regional transportation authorities, and is not expended by the counties.)

Cities and Towns

By law, tradition, politics, and economics, Arizona cities and towns serve many functions. (Cities and towns are also called municipalities.) The Arizona Constitution and state law permit two types of municipalities: general law and home rule charter. Currently, 64 of the 83 municipalities operate under general law. This means that the cities cannot take action in an area without enabling authority in state statutes.

According to the Constitution, any city with a population over 3,500 may "frame a charter for its own government." The charter and subsequent amendments to it are voted upon by the

qualified electors in the city, and must be consistent with the Constitution and state laws. A charter is comparable to a constitution in that it outlines the city's governmental structure and provides enabling authority for self-rule. Charter government offers basic jurisdiction and authority and permits each city to determine its own governmental structure.

While the larger cities in Arizona tend to have charter governments, several smaller cities have adopted charters as well. Charter cities have more flexibility than general law cities in determining their organizational structure, but they often have less fiscal flexibility because their own charters impose fiscal constraints that are not imposed on general law cities by the Constitution or state statute. Although charter cities may implement some specific programs that general law cities are not authorized to administer, both types of cities are involved in the same broad categories of governmental services.

The goods and services provided by Arizona cities vary. A typical list of city services includes:

- * police and fire protection
- * planning, zoning, and building inspections
- * parks and recreation facilities
- * garbage collection
- * libraries
- * road maintenance

Additional services provided by many cities include:

- * water systems
- * sewage and waste disposal
- * sanitary landfills
- * economic development
- * mass transportation systems
- * airports

To finance these services, Arizona municipalities can draw on a relatively diverse revenue base. Basic local revenue sources for cities and towns are:

- * property taxes
- * sales taxes
- * franchise taxes
- * business license taxes
- * use taxes
- * bed taxes
- * various user and permit fees, service charges, and fines

In addition, Arizona municipalities may raise revenues for direct local expenditure with the following tools:

- * General obligation bonds
- * Revenue bonds
- * Street improvement bonds
- * Special improvement district bonds and community facilities district bonds

By state law, cities are prohibited from imposing local gas taxes, income taxes, or luxury taxes.

School Districts

School districts for elementary and secondary education are political subdivisions of the State "organized for the purpose of the administration, support and maintenance of the public schools..." (ARS 15-101 (15)) They are authorized by law to make expenditures in accordance with this purpose. School districts depend on the following revenue sources to finance education expenditures: state aid, the state-mandated county property tax for education, federal aid, school district property taxes, and user fees and charges.

Community college districts are subdivisions organized to operate community colleges. They are organized along county boundaries and consist of one county or two or more contiguous counties. They are funded through state aid, county property taxes, and tuition and other user charges.

Special Districts

Special districts are limited-purpose, independent governmental units which exist as separate entities with substantial administrative and fiscal independence from general purpose local governments. These districts provide services such as crop protection, fire protection, hospitals, mosquito abatement, and sanitation sewer systems. Every special district is formed and organized following the enabling authority of the particular type of district. Specific authorizations and limitations for each type of district are contained in the district's enabling statute. Special districts are financed by a variety of means, including levying taxes on property within each district, charging user fees to service recipients, and issuing revenue and general obligation bonds.

STATE AND LOCAL EXPENDITURES

In Arizona in FY 1987, total direct general expenditures by the state were 3.4 billion dollars while total direct general expenditures by local governments were 6.1 billion dollars. As shown in Table 2, state expenditures were fairly evenly divided between education, social services, and transportation, with

Table 2
 DIRECT EXPENDITURE MIX OF STATE AND LOCAL GOVERNMENTS
 FY 1986-87
 (percentages)

ARIZONA	Education	Social Services	Transportation	Public Safety	Env. & Housing	Administration	Other	Total
State	29.7	23.3	22.4	10.6	2.3	5.7	6.0	100.0
Total Local	44.1	6.1	9.5	10.2	11.3	6.3	12.4	100.0
County	1.4	25.4	10.6	13.3	10.1	14.1	25.2	100.0
Municipal	3.6	0.2	23.4	22.9	23.5	10.4	15.9	100.0
School Dist.	96.0	0.0	0.0	0.0	0.0	0.0	4.0	100.0
Special Dist.	0	10	0	11	73	0	5	100.0

U.S.	Education	Social Services	Transportation	Public Safety	Env. & Housing	Administration	Other	Total
State	23.6	34.7	12.4	6.6	4.2	5.1	13.4	100.0
Total Local	43.0	12.5	7.0	10.1	11.0	5.5	11.1	100.0
County	14.7	30.2	9.7	11.9	7.2	12.1	14.1	100.0
Municipal	13.9	9.7	11.7	20.2	19.8	7.7	17.0	100.0
School Dist.	98.2	0.0	0.0	0.0	0.0	0.0	1.8	100.0
Special Dist.	1.8	28.1	9.3	5.0	37.0	0.0	18.9	100.0

Source: Governmental Finances, U.S. Department of Commerce, Bureau of the Census, FY 1986-87.

fewer dollars being spent on public safety, environment and housing, and all other types of services. The State of Arizona spent a lower percentage of total expenditures on social services than the percentage spent by all U.S. states, and Arizona spent a higher percentage on transportation than the U.S. total.

As Table 2 illustrates, the bulk of total local expenditures go toward education. County governments in Arizona spent the largest portion of their funds on social services and spent almost nothing on education. Arizona municipalities spent just under one quarter of their funds on each of the three expenditure categories of public safety, environment and housing, and transportation; this percentage spending on transportation was approximately double the percentage spent on transportation by all municipalities in the U.S. School districts, of course, spent almost all of their funds on education. Special districts in Arizona spent nearly three quarters of their funds on natural resources and sewers (in the environment and housing category), 11 percent of their funds on public safety, and 10 percent on social services; aggregate special district expenditures in the U.S., by contrast, included 28 percent on social services and 37 percent on environment and housing.

For both Arizona and the U.S. total, the state expended the majority of total state and local funds spent on social services and transportation, while local governments expended the majority on all other expenditure categories, and the majority of total state and local spending.

Table 3 illustrates the distribution of local expenditure responsibility by category in Arizona and the total U.S. for FY 1987. In Arizona, school districts spent 97 percent of all local education expenditures. Counties in Arizona expended 95 percent of all local social services spending, while for the total U.S., special districts and municipalities made 42 percent of the local social services expenditures. Arizona local transportation expenditures showed an approximate 75/25 percent split between municipalities and counties, while the U.S. total split was closer to 60/30 percent with special districts spending the remainder.

STATE AND LOCAL REVENUES

In FY 1987, the State of Arizona received 58 percent of total state and local general revenues. The mix of state revenue sources is shown in Table 4. Thirty percent of Arizona state revenue was generated by the sales tax compared to 19 percent from the sales tax for all states. Arizona funds generated from user charges, federal aid, and income taxes, and other taxes, ranged between 14 and 18 percent of total state revenue, with local aid and property taxes making up much smaller portions of the total mix.

Table 3
 LOCAL EXPENDITURE RESPONSIBILITY BY CATEGORY
 FY 1986-87
 (thousands of dollars and percentages)

ARIZONA	Total Local Expenditures	Percentage spent by Counties	Percentage spent by Municipalities	Percentage spent by School Districts	Percentage spent by Special Districts	TOTAL
Education	\$2,678,054	0.7	2.5	96.8	0.0	100%
Social Services	372,558	94.5	1.1	0.0	4.3	100%
Transportation	574,294	25.6	74.4	0.0	0.0	100%
Public Safety	621,257	29.8	67.4	0.0	2.8	100%
Env. & Housing	682,936	20.5	62.9	0.0	16.7	100%
Administration	384,853	50.7	49.3	0.0	0.0	100%
Other	755,273	46.3	38.5	14.2	1.0	100%
Total	\$6,069,225	22.9	30.1	44.5	2.6	100%

U.S.	Total Local Expenditures	Percentage spent by Counties	Percentage spent by Municipalities	Percentage spent by School Districts	Percentage spent by Special Districts	TOTAL
Education	\$167,996,117	8.3	11.0	80.5	0.3	100%
Social Services	48,746,724	58.4	26.4	0.0	15.1	100%
Transportation	27,215,636	33.7	57.3	0.0	8.9	100%
Public Safety	39,359,351	28.5	68.2	0.0	3.3	100%
Env. & Housing	42,861,173	15.9	61.4	0.0	22.7	100%
Administration	21,556,543	52.8	47.2	0.0	0.0	100%
Other	43,359,550	30.7	52.1	5.8	11.4	100%
Total	\$391,095,094	24.1	34.0	35.2	6.7	100%

Source: Governmental Finances, U.S. Department of Commerce,
 Bureau of the Census, FY 1986-87

Table 4
 STATE GOVERNMENT GENERAL REVENUE MIX
 (Millions of dollars and percentages)
 FY 1986-1987

	ARIZONA	U.S.
Total general revenues	\$5,213.5	\$419,486.7
% from federal aid	17.5%	22.8%
% from local aid	1.7%	1.6%
% from income tax	18.4%	23.0%
% from sales tax	29.7%	19.0%
% from property tax	2.2%	1.1%
% from other taxes	16.2%	15.7%
% from charges & misc.	14.3%	16.7%
	100.0%	100.0%

Source: Governmental Finances, U.S. Department of Commerce, Bureau of the Census, FY 1986-87.

Table 5 shows the mix of revenues raised by local governments (excluding intergovernmental aid) in Arizona and the U.S. between FY 1977 and FY 1987. Total Arizona local governments received 46 percent of their own-source revenues from user charges in FY 1987, 41 percent from property taxes, and 13 percent from other types of taxes. The table illustrates the decline in city and county reliance on property taxes over the 10-year period, and the corresponding increase in the reliance on user charges and fees. This trend reflects the citizen tax revolts of the early 1980's and the resultant limitations on local property taxes. While aggregate special districts in the U.S. followed this same pattern, special districts in Arizona increased their reliance on property taxes from 10 percent of

TABLE 5
LOCAL GOVERNMENT OWN SOURCE REVENUE MIX
(millions of dollars and percentages)

	ARIZONA			U.S.		
	FY 1976-77	1981-82	1986-87	FY 1976-77	1981-82	1986-87
Total Local Governments:	\$1,008.8	\$1,874.2	\$3,549.4	\$102,030.7	\$163,240.0	\$254,062.4
% from property taxes	59.3%	40.9%	41.4%	59.1%	48.3%	45.9%
% from other taxes	13.8%	13.7%	13.0%	14.2%	15.2%	16.4%
% from charges & misc.	26.9%	45.3%	45.6%	26.7%	36.5%	37.7%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Counties:	\$254.1	\$487.5	\$1,061.3	\$22,653.7	\$38,350.3	\$63,988.7
% from property taxes	75.8%	44.4%	39.2%	56.9%	46.2%	42.8%
% from other taxes	3.2%	2.4%	2.1%	13.1%	13.6%	15.4%
% from charges & misc.	20.9%	53.2%	58.7%	30.0%	40.2%	41.8%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Municipalities & Townships:	\$292.8	\$611.3	\$1,249.4	\$41,343.4	\$66,504.2	\$102,677.9
% from property taxes	20.8%	14.2%	12.7%	46.9%	36.8%	33.7%
% from other taxes	44.8%	40.1%	35.0%	26.0%	26.9%	28.1%
% from charges & misc.	34.4%	45.7%	52.2%	27.1%	36.2%	38.2%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
School Districts:	\$408.0	\$614.9	\$1,059.3	\$31,425.9	\$44,177.0	\$61,979.1
% from property taxes	83.1%	73.8%	81.5%	84.6%	77.9%	81.5%
% from other taxes	0.0%	0.0%	0.0%	2.2%	2.6%	2.1%
% from charges & misc.	16.8%	26.2%	18.5%	13.3%	19.5%	16.4%
	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Special Districts:	\$53.9	\$160.4	\$179.4	\$6,599.6	\$14,208.5	\$25,416.8
% from property taxes	10.4%	6.5%	17.6%	21.8%	15.4%	16.2%
% from other taxes	0.0%	0.0%	0.0%	2.2%	2.6%	2.1%
% from charges & misc.	89.6%	93.5%	82.4%	76.5%	80.5%	77.6%
	100.0%	100.0%	100.0%	100.4%	98.4%	96.0%

Source: Governmental Finances, U.S. Department of Commerce, Bureau of the Census, selected years.

total special district revenue in FY 1977 to 18 percent of total revenue in FY 1987. For school districts, property tax reliance decreased between 1977 and 1982, but subsequently rose so that the 1987 reliance level was close to the 1977 level. All types of Arizona local governments rely more heavily on user fees and charges than do total local governments in the U.S. Arizona counties rely less on non-property taxes than do counties in the U.S. aggregate, and Arizona municipalities rely more heavily on non-property taxes -- primarily sales taxes -- than municipalities in the U.S. aggregate.

Table 6 shows the distribution of property taxes raised by level of government in 1977 and 1987. In Arizona, the state share of total property taxes diminished during that period and the school district share of total property taxes increased. The drop in the state share reflects the drop in the state property tax rate from \$1.60 per \$100 of assessed value in FY 1977 to \$0.38 per \$100 of assessed value in FY 1987. In FY 1987 Arizona municipalities received a smaller share of total property taxes than municipalities in the U.S. aggregate, and Arizona school districts received a greater share of total property taxes than the U.S. aggregate.

Table 7 illustrates another fiscal trend that occurred in the U.S. and Arizona between 1977 and 1987: while the actual amount of federal dollars distributed to state and local governments grew, other sources of revenue grew at a faster rate,

Table 6
 PERCENTAGE OF TOTAL PROPERTY TAXES RAISED BY LEVEL OF GOVERNMENT
 (millions of dollars and percentages)

	----- ARIZONA -----		----- U.S. -----	
	1976-77	1986-87	1976-77	1986-87
Total property taxes	\$727.9	\$1,584.4	\$62,534.9	\$121,226.9
State	17.8%	7.2%	3.6%	3.8%
County	26.5%	26.2%	20.6%	22.6%
Municipality	8.4%	10.0%	31.0%	28.6%
School District	46.6%	54.5%	42.5%	41.6%
Special District	0.8%	2.0%	2.3%	3.4%
	100.0%	100.0%	100.0%	100.0%

Source: Governmental Finances, U.S. Department of Commerce,
 Bureau of the Census, selected years.

Table 7
 FEDERAL AID AS A SHARE OF TOTAL GENERAL REVENUE
 (millions of dollars and percentages)

	ARIZONA		U.S.	
	1976-77	1986-87	1976-77	1986-87
State government	\$363.6	\$912.9	\$45,938.3	\$95,462.9
	21.0%	17.5%	27.0%	22.8%
Total local government	\$160.0	\$263.1	\$16,636.9	\$19,532.6
	8.6%	4.4%	9.3%	4.8%

Source: Governmental Finances, U.S. Department of Commerce,
 Bureau of the Census, selected years.

so that state and local government reliance on federal funds diminished.

REVENUE AND EXPENDITURE LIMITS

Government revenues and expenditures are determined by the decisions elected officials make regarding taxes and budgets. Because citizens elect the policy-makers, revenues and expenditures are indirectly determined by the voters. In most states, voters have expressed their tax and spending preferences in a more direct way by enacting constitutional limits on the amount of revenue governments can raise and on the amount of funds governments can expend. Many of these limits were created in the late 1970's and early 1980's during the taxpayer revolt. Taxpayers in California were concerned that their governments would continue to grow dramatically and unchecked, and that their tax bills would continue to grow accordingly. Voters there enacted "Proposition 13," a strict limit on property tax revenues and expenditures of local governments. Taxpayers in other states began to voice the same concerns, and policy-makers and voters established variations of Proposition 13 all around the country.

As part of this trend, the Arizona Legislature and voters enacted a series of revenue and expenditure limits in 1978 and 1980. These limits are described in Table 8. As the table shows, the state and every type of local government, except special districts, are subject to some sort of revenue or expenditure limit. It is important to note that special

TABLE 8
ARIZONA REVENUE AND EXPENDITURE LIMITS

LEVEL OF GOVERNMENT	LIMIT	SOURCE	EXEMPTIONS	OVERRIDES	DATE ENACTED
State	Appropriation Limit appropriations limited to 7% of state personal income, adjusted to 7.18% to account for the county contribution to the AHCCCS appropriation	Constitution IX, 17 (3)	specific situations listed in Constitution	2/3 vote of each house of State Legislature	1978
All	Property Tax Limit total homeowner primary property tax bill is limited to 1% of primary assessed valuation; and growth in locally assessed primary valuation is limited	Constitution IX, 18 (1)	special districts, items in the secondary tax	No	1980
County, City, Community College District	Property Tax Levy Limit growth in primary property tax levy is limited to 2% over previous year plus the value of new construction	Constitution IX, 19	special districts, county school taxes	by vote of the people	1980
County, City	Expenditure Limit limited to 1980 level plus cost of living and population increases and annexations	Constitution IX, 20	specific items listed in Constitution	Governor-declared emergencies, vote of the people for change to base limit, cities can submit an alternative expenditure limit to a vote of the people	1980
Community College District	Expenditure Limit limited to 1980 level plus cost of living and student population increases	Constitution IX, 21	specific items listed in Constitution	No	1980
All School Districts	Aggregate Expenditure Limit limited to 1980 level plus cost of living and student population increases	Constitution IX, 21	specific items listed in Constitution	2/3 vote of each house of State Legislature	1980
Each School District	Expenditure Limit limited according to formula based on student counts and cost factors	Statute	specific exemptions prescribed in law, items in the secondary tax	by vote of the people	1980

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districts fall outside local government revenue and expenditure limits. This is one reason for the dramatic growth in the number of special districts in Arizona between 1977 and 1987 (a 139 percent increase during that period). In recent years the counties have become tightly constrained by their revenue and expenditure limits. When the Legislature has identified the need for certain programs or services in several cases, lawmakers have established new special districts with specific revenue-raising authority in order to provide the desired services without further straining county budgets.

Although most of the revenue and expenditure limits are contained in the Constitution, their details and implementation procedures are further defined in statute. As described in Table 8, most of the limits exempt certain items and allow the jurisdictions to override the limits under certain conditions through specified procedures. Because of economic conditions, exemptions, and override opportunities, some of the limits have not placed real constraints on the government units. For a number of years, for example, state revenues were significantly below the Constitutional appropriation limit of 7 percent of state personal income, so that available revenues constrained the State budget. For community college districts, school districts, and counties, on the other hand, the revenue and/or expenditure limits have imposed real constraints on tax and spending decisions.

STATE AID

In U.S. intergovernmental fiscal systems, a portion of revenues raised by the states is often distributed to local governments for local expenditure. There are several reasons for this state aid to local governments.

One purpose of state aid is fiscal equalization. It is usually the case that local jurisdictions within a state vary greatly in their wealth--measured by property values or income--and, thus, vary in their ability to raise revenue and provide government services. In order to make tax burdens and service levels more equal throughout the state, state governments often appropriate or distribute funds to local governments based on some measure of jurisdictional wealth or need. These state aid formulas provide greater resources to jurisdictions with lesser wealth or greater service needs to bring these areas closer to the statewide average.

A second purpose of state aid is to target funds to specific program areas to address specific needs. State policy-makers may identify issues of statewide importance that cannot be adequately addressed by individual jurisdictions. In these cases, the state may provide local governments with service authority and responsibility, and provide them with the corresponding funding, rather than create state agencies to administer the programs.

A third purpose of state aid is to increase the provision of local government services whose benefits "spill over" into other local jurisdictions. A spillover, or externality, occurs when

the benefits of a government service are felt outside the boundaries of the jurisdiction that is providing the service. When this happens, the jurisdiction will choose an inefficiently low level of public goods and services because the decision-makers do not take into account the benefits accruing to non-residents. From the statewide perspective, it would be more efficient and beneficial to provide a greater level of the service in question. By providing fiscal aid, the state can encourage the local jurisdiction to produce greater levels of the service.

Table 9 shows the distribution of state aid to local governments in Arizona and the U.S. aggregate between 1977 and 1987. Note that because these data are collected nationally for the purpose of interstate comparisons, "state aid" includes state payments to local governments for contracted services and other purchases in addition to state appropriations to local governments and state shared revenues. (This definition is also true for Tables 11 and 13.) Total state aid to local governments grew by 206 percent in Arizona during the ten-year period, while the U.S. aggregate state aid grew by 126 percent. The shares of Arizona state aid distributed to counties and municipalities grew between 1977 and 1987, while the share distributed to school districts diminished. In 1987 the Arizona distribution looked very similar to the U.S. distribution, with over half of state aid going to school districts and the remainder being split nearly evenly between counties and municipalities.

Table 9
 DISTRIBUTION OF STATE AID BY TYPE OF LOCAL GOVERNMENT
 (millions of dollars and percentages)

	----- ARIZONA -----		----- U.S. -----	
	1976-77	1986-87	1976-77	1986-87
Total State to Local	\$693.4	\$2,124.4	\$60,311.4	\$136,752.4
Counties	16.7%	21.9%	23.7%	23.5%
Municipalities	17.8%	22.0%	25.8%	21.6%
School districts	65.5%	56.0%	49.2%	53.5%
Special districts	0.0%	0.1%	1.3%	1.4%
	100.0%	100.0%	100.0%	100.0%

Source: Governmental Finances, U.S. Department of Commerce,
 Bureau of the Census, selected years.

Shared Revenues

There are two major types of state aid in Arizona: state shared revenues and state aid appropriations for education. Arizona state shared revenues are described in Table 10. The distributions of sales, income, and motor vehicle license tax revenues are for general governmental purposes -- recipient local governments can spend the funds on any valid government purpose. The distributions of Highway User Revenue Funds (known as HURF, this fund contains the revenue from the fuel tax and a variety of fees, fines and other proceeds) and lottery receipts must be spent on transportation. Note that all of the distribution formulas are based, at least in part, on population. This is true because population serves as a measure of service need that is relatively easy to calculate and to understand.

The sales tax distribution to counties is based in part on the net assessed secondary property valuation in each county: the higher the valuation, the greater the amount of revenue distributed. This distribution method seems to run counter to the equalization goal of state aid described above, since the wealthier jurisdictions receive more state funds. The distribution of HURF funds is partially based on place of origin of fuel sales, which is a measure that is not directly related to wealth but may be indirectly related to need if the volume of sales reflects the extent of vehicle use of local roads.

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with income
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Table 10
Distribution of Shared State Revenues

Tax	Structure	Cities	Counties	State	Factors That Determine Shares
Sales Tax	Base for distribution is a varying percent of taxable activities	25%	38.08%	36.92%	Cities: population Counties: 1. Net assessed valuation 2. County origin of sale
Income Tax	Urban Revenue Sharing	15% net Individual and Corporation income taxes received two years prior to current fiscal year	None		population
Highway User Revenue Fund (HURF)	3 cents/gal motor fuel or use fuel tax	14% to Counties with pop. of 1,400,000 or more (shared with cities) 8.5% to counties with pop. between 400,000 and 1,400,000 (shared with cities) 8% to counties with pop <400,000 5.5% to cities in counties with pop < 400,000		64%	Cities: population Counties: population in unincorporated areas
	All remaining HURF revenues	30%	20%	50% ¹	Cities: 1. population 2. County origin of sale Counties: origin of sale

¹ 93% to state highway fund, 7% to cities with population greater than 300,000 shared per population.

Table 10 (Continued)
Distribution of Shared State Revenues

Tax	Structure	Cities	Counties	State	Factors That Determine Shares
Motor Vehicle License Tax	County Treasurer Distributes 31.5% of all receipts to HURF				
	All remaining receipts ²	25%	25%	45%	Cities: population Counties: origin of receipt 5% cost of admin.
Lottery receipts	\$23,000,000 to local transportation assistance fund (exp 7-1-91)	100%			Cities: population
	\$7,650,000 to county assistance fund		93.47% to counties with pop <500,000 6.63% to counties with pop >500,000		Counties: 1/13 of the 93.47% amount to each of 13 counties, and 1/2 of the 6.63% amount to each of the 2 largest counties
	Remaining lottery receipts after admin. costs and prize monies			remainder	

² Special provision if annual tax growth exceeds 7%, then excess of general fund share is deposited to HURF in nine monthly payments from general fund share of following years receipts.

State Aid for Education

There are three major types of state aid appropriations for education. The distribution of basic state aid to schools is based on the number of students, educational cost factors, and the property wealth within each school district. The formula provides less (or no) aid to districts with greater wealth and, thus, serves an equalizing function. The appropriation of additional state aid to schools, also known as the homeowner's rebate, serves as a property tax relief measure for homeowners. Through this program, school districts are required to reduce homeowner property tax bills by 56 percent (with a maximum reduction of \$500). The districts are then reimbursed by the state with state general fund revenues. Similarly, if a homeowner's total primary property tax bill is above 1 percent of assessed valuation, the school district reduces the tax bill to the 1 percent level and is reimbursed by the state. So, while these measures allow homeowners to pay lower property taxes to their school districts, the tax bills of other property owners and the total revenues and expenditures of school districts are unaffected. The distribution of state aid to community college districts is based on student populations and assessed property valuation.

The Significance of State Aid in Arizona

How important is state aid in Arizona's intergovernmental fiscal system? Table 11 illustrates the extent to which local governments rely on state aid. The data show that school districts rely the most heavily on state aid, receiving approximately half their total revenue from state aid, both in Arizona and the U.S. While counties and cities rely less on state aid than do school districts, they still depend on state aid to a significant degree (29 percent for counties and 25 percent for municipalities in Arizona in 1987).

In fact, distributions of state aid to local governments make a significant difference in the overall fiscal pattern of the state as can be seen from Table 12. The table shows that the state shares of both total state and local revenues and expenditures in Arizona are below the state shares of the U.S. total, meaning that the Arizona fiscal system is a relatively decentralized one. While the state of Arizona raised 58 percent of the total state and local revenue, the state spent only 36 percent of the total state and local expenditures. The state share of expenditures is lower than the state share of revenues because the state distributes a significant portion of its revenues for expenditure at the local level. Table 13 shows that the state of Arizona distributed 41 percent of its revenue to local governments in 1987. This is above the total U.S. distribution of 33 percent.

Table 14 A shows the dollar amounts and percentage distribution of the major types of state shared revenues. In FY

Table 11
STATE AID AS A SHARE OF TOTAL GENERAL REVENUE

	ARIZONA			U.S.		
	1976-77	1981-82	1986-87	1976-77	1981-82	1986-87
Tot. Local Governments	37.2%	37.3%	35.8%	33.7%	34.0%	33.3%
Counties	26.9%	26.7%	29.0%	34.5%	34.3%	31.7%
Municipalities	24.5%	24.4%	24.9%	23.1%	20.9%	20.5%
School Districts	50.6%	53.1%	49.5%	46.8%	51.6%	52.8%
Special Districts	0.0%	1.0%	1.2%	7.0%	6.7%	5.3%

Source: Governmental Finances, U.S. Department of Commerce,
Bureau of the Census, selected years.

Table 12
STATE SHARE OF TOTAL STATE AND LOCAL GENERAL REVENUES
AND DIRECT EXPENDITURES FOR FY 1986-87

	Arizona	U.S.
Revenue	58.3%	61.1%
Expenditures	36.0%	40.2%

Source: Governmental Finances, U.S. Department of Commerce,
Bureau of the Census, FY 1986-87

Table 13
PERCENTAGE OF STATE GENERAL REVENUES DISTRIBUTED
TO LOCAL GOVERNMENTS

	1986-87
Arizona	40.7%
U.S.	32.6%

Source: Governmental Finances, U.S. Department
of Commerce, Bureau of Census,
FY 1986-87

TABLE 14-A
STATE AID
Four Major Types of Shared Tax Revenue
(dollar figures in thousands rounded to the nearest thousand)

	FY 1984	%	FY 1988	%
Sales Tax				
Total State Collections	\$1,141,224		\$1,597,770	
Distributed to Cities	105,144	9.2%	136,877	8.6%
Distributed to Counties	181,255 *	15.9%	208,491	13.0%
Net to State	854,825	74.9%	1,252,402	78.4%
		100%		100%
Income Tax				
Total State Collections	724,594		1,004,729	
Distributed to Cities	83,062	11.5%	130,653	13.0%
Net to State	641,532	88.5%	874,076	87.0%
		100%		100%
Highway User Revenue Fund				
Total State Collections	389,598		607,383	
Distributed to Cities	12,549	3.2%	216,899	35.7%
Distributed to Counties	74,920	19.2%	116,909	19.2%
Net to State	302,129	77.5%	273,575	45.0%
		100%		100%
Lottery Receipts				
Net State Collections**	21,310		66,347	
Distributed to Cities	18,000	84.5%	23,000	34.7%
Distributed to Counties	0	0.0%	7,650	11.5%
Net to State	3,310	15.5%	35,697	53.8%
		100%		100%

* includes a \$25 million one-year special distribution

** after prizes, retailer commissions, and administrative expenses paid

Sources: Arizona Department of Transportation, Administrative Services Divison, Office of Fiscal Planning; Department of Revenue Annual Reports, selected years; Arizona State Lottery

TABLE 14-B
 STATE AID
 Major Expenditures on Education Aid as a Share
 of State General Fund Revenue
 FY 1987-88
 (in thousands of dollars and percentages)

Total State General Fund Revenue	\$2,563,118.1	
State General Fund Expenditures by School Districts for Basic State Aid	852,639.3	33.3%
State General Fund Expenditures by School Districts for Additional State Aid	141,081.2	5.5%
State General Fund Expenditures by Community College Districts for Operating, Capital Outlay and Equalization Aid	67,588.6	2.6%
Total Major Education Aid Expenditures	\$1,061,309.1	41.4%

Source: State of Arizona Annual Financial Report, FY 1987-1988.

1988 the state distributed 22 percent of state sales tax revenue, 13 percent of income tax revenue, 55 percent of HURF revenue, and 46 percent of lottery receipts to local governments. As the table illustrates, Arizona cities and counties receive relatively large dollar distribution for general government purposes, with no strings attached. Table 14 B shows the amounts expended from the State general fund by local jurisdictions in the three major state aid for education formulas. The data show that in FY 1988, the expenditures for these three formulas represented 41 percent of total state general fund revenues.

CONCLUSION

Intergovernmental fiscal relations in Arizona significantly affect the pattern of total state and local government revenues and expenditures. Arizona's fiscal system is relatively decentralized compared to other states, with extensive expenditure authority residing in local governments. Arizona intergovernmental fiscal ties are strong relative to other states: Arizona local governments depend more on state aid than do local governments in the U.S. as a whole, and the state of Arizona distributes a greater share of its state revenue to local governments. Because of these fiscal interrelationships, changes to the state's fiscal system cannot be thoroughly evaluated without examining potential impacts on local government operations.