TABLE OF CONTENTS

AGENDA

ARIZONA JOINT SELECT COMMITTEE ON
STATE REVENUES AND EXPENDITURES

JANUARY 25, 1989

1. Call to Order, 4:00 p.m.
   Hearing Room 2, House of Representatives
   Phoenix

2. Approval of January 11, 1989 Minutes

3. Presentation of Research Paper (Tab B):
   Criteria for Evaluating Fiscal Systems

4. Presentation of Research Paper (Tab C):
   Interstate Fiscal Comparisons

5. Other Business

6. Adjournment, 7:00 p.m. (estimated)

Minutes of Meeting

JOINT SELECT COMMITTEE ON STATE REVENUES EXPENDITURES

Wednesday, January 11, 1989

A meeting of the Joint Select Committee on State Revenues and Expenditures was held in Hearing Room 2 of the House of Representatives, at 4:00 p.m. on Wednesday, January 11, 1989, with Chairman J. Elliott Hibbs presiding.

Members Present

Jose Cardenas	Sen. Jaime Gutierrez	Rep. Art Hamilton
Don Bliss	Leonard Judd	J. Elliott Hibbs
Sharon Medgal	Rep. Mark Killian	Richard Snell
Sen. Jeffrey Hill	Rep. Chris Herstam	Sen. Robert Usdane
John Stiteler	Wayne Brown	

Also present at the meeting was Staff Director Dr. Therese J. McGuire.

Members Absent

Hon. C. Diane Bishop

By a motion made by Mr. Bliss, seconded by Mr. Snell, the minutes of the October 17th meeting were approved.

Chairman Hibbs, welcomed Representative Mark Killian to the Committee. He replaces Representative John King, who did not win re-election.

DISCUSSION OF PUBLIC HEARINGS

Dr. McGuire highlighted several issues that were brought up during the four public hearings held in Flagstaff, Yuma, Phoenix and Tucson. She also stated that each of these issues will be addressed by the consultants in one or more of the research reports prepared for the committee. Dr. McGuire confirmed that the public hearings were very useful in identifying issues and information available. Chairman Hibbs directed staff to distribute to committee members a summary list of the issues and concerns identified during those hearings.

Mr. Bliss questioned whether or not the Committee would go back to the public later in the process and especially at the end when considering policy recommendations. Chairman Hibbs stated that that question would be addressed later in the agenda.

Dr. Megdal added that she would also like to see any correspondence that staff received as a result of the hearings. Dr. McGuire noted that the docket book for this meeting only contained the actual transcripts of the hearings. Correspondence would be included in future docket books according to their relationship to topics on the Calendar.

DIRECTOR'S REPORT ON RESEARCH PROGRESS

Referencing the Committee's calendar, Dr. McGuire stated that research reports were being conducted on each of the topics that will be addressed. The reports were being done by some of the best public finance economists in Arizona and throughout the country.

She stated that the research process for each topic report consists of a series of steps:

Step 1. Identify the issues and the availability of information and data and other relevant reports and studies through meetings with local experts.

Step 2. Outline the study so that it addresses issues identified using methodology that employs the available information.

Step 3. Do the research as outlined.

Step 4. Written and oral presentations of the analysis.

Dr. McGuire continued to illustrate the process by reviewing outlines of two studies currently underway. One, on the general sales tax, which really is a transactions privilege tax, consisted of four areas:

1. The description of the structure, its rationale and role and interstate comparisons.

2. Evaluate the current structure, in terms of stability and responsiveness, and the distribution of the burden.

3. Consideration of changes to structure, including base broadening, and evaluation of stability and burden.

4. Look at the cost of compliance and administration involved, and state and local differences in tax base definition.

The other study, on the Arizona economy and business climate, was outlined as follows:

1. Describe industrial mix of Arizona today and in the past and compare it to other states.

2. Compare Arizona job growth rate with other states.

3. Ask why the differences in job growth rates. What factors across the states help to explain the differences in unemployment growth rates? An econometric model will determine correlations.

4. Compare Arizona with other states on the factors identified by the model.

Attached to each research report will be an executive summary and a set of findings or policy options, whichever is relevant. Twenty to twenty-five reports will cover all areas listed on the calendar. These reports are being prepared by some of the best public fiance economics in the country and the state. Dana Naimark, Project Manager and Dr. McGuire will be heavily involved in each each step of the process on each report. Deadlines have been set for each researcher that are consistent with the scheduled Committee meetings. Many of the reports are well underway. Topics such as K-12 and property taxes have been placed later in the calendar to allow enough time for a high quality job on these areas.

Dr. McGuire proceeded to report on the Committee's part in the process. She explained that approximately one week prior to each meeting, Committee members will receive a docket book containing relevant research reports and summaries to review. Brief presentations on the reports will be given at the meeting followed by a question and answer period and discussion of the information and options presented. No votes will be taken until all the reports and information have been presented. The rationale for this procedure is to insure that the Committee meetings are devoted to fact-finding and information gathering, and since many components of the fiscal system are intimately linked to one another, component by component recommendations are not likely to be consistent.

After all the research is completed and presented, the Committee will meet to make policy recommendations on the final package. Staff will be able to pull together various policy options for consideration by the Committee. Any recommendations made will be based on nine months of fact finding and analytical evaluations.

Over the last few months researchers have been identified for all the topics. Half a dozen of the researchers are on Step 3 of the process with research well underway. Another half a dozen are on Step 2, outlining methodology. The remaining dozen or so are on Step 1--identifying issues, data and information.

The January 25 meeting will cover two reports on background-- Criteria for Evaluating Fiscal Systems and Fiscal Comparisons with Other States.

The Criteria report is a conceptual report--no data gathering or analysis is involved. It defines principles or criteria to be used in evaluating components of the fiscal system. The report will define and discuss criteria such as equity, efficiency, simplicity, stability, accountability, neutrality and competitiveness (economic development). The Committee may want to formally adopt or chose a set of criteria at the January 25th meeting to provide a framework for the research meetings to follow.

Questions turned again to the subject of public input. Dr. McGuire stated that interested parties may provide input by submitting any information or reports to staff. Local experts will also provide input through meetings with consultants.

Once all the reports are completed and prior to the policy recommendations, the public may provide input by submitting five-page typewritten documents stating their reactions to the reports. These documents will then be reviewed by staff and distributed to Committee members.

Concerns were then expressed on the notification and the advertising of the Committee's process to the public. Many people do not know who or what we are and more needs to be done to ensure that everyone receives a chance to give input. It was suggested that the media be utilized more through press releases and interviews in order to make the public more aware of the Committee's work.

Discussions then turned to the qualifications and the expertise of the consultants. Dr. McGuire noted that all the consultants have prior experience and expertise in their area of study. They are all Ph. D. economists from academic institutions and are experts in state and local finance. They have met with local experts pertaining to their area. For instance, the sales tax consultants are meeting with representatives from the League of Cities and Towns and County Supervisors and Department of Revenue. Concerns were expressed on the lack of input that the Committee felt they had in the selection of these consultants. Chairman Hibbs interjected that the Committee agreed to give Dr. McGuire the authority to pick the consultants. He went on to explain that she went to great efforts to meet with potential consultants at ASU and UofA as well as out-of-state. Following further discussion, Chairman Hibbs directed staff to provide copies of each consultant's resume to Committee members. Chairman Hibbs reiterated what Dr. McGuire said earlier that the consultants were only to provide information and the pros and cons of the problems identified by the Committee members. It is up to Committee members to make the final recommendations based on the information.

Discussion then turned to modeling and its capabilities and time factors. Senator Hill expressed concerns regarding the use of models in the past and the amount of time that it took to get results based on different factors. He also wanted to know when these models would be available, if not already. Dr. McGuire explained that a set of models would be available as the reports were available along the lines of the Calendar. Dr. Megdal questioned the availability of current econometric models. Dr. McGuire and Chairman Hibbs explained that several forecasting models are available from the Universities and other sources and the Department of Revenue has an income tax model but it is not up yet. Senator Hill requested that modeling and its process be addressed at the next meeting.

Other Business

Representative Herstam distributed copies of a revised version of the Committee's Calendar. He explained that he changed the calendar by speeding up the process by eliminating the Executive Summary meeting, reducing the discussion of final recommendations from four days to two days and setting the delivery of the final report 20 days earlier.

In doing this, he hoped that the Legislature would be able to address the final recommendations of the Committee during a special session slightly earlier than originally anticipated. Representative Herstam made the motion that the revised Calendar, dated January 11, 1989, be adopted by the Committee. The motion was seconded by Representative Killian.

Senator Hill made the motion to further amend the Calendar by moving the property tax area up. Following discussion on the process and the time needed to study this area, the motion failed due to the lack of a second on the motion.

Discussion then turned to the Calendar. Dr. McGuire stated that speeding up the process by three weeks would not affect the quality of the research and it was satisfactory to do so. By a roll-call vote of 14-0 in favor, the motion passed unanimously.

Senator Usdane apologized for being late. He wanted to notify the Committee that he was taking himself off of the Committee due to time constraints associated with his position as President of the Senate. He has asked Senator John Mawhinney to take his place and stated that Senator Mawhinney had indeed sat through the Committee's meeting as an observer. Senator Usdane also wanted to emphasize the importance of the Committee and that the Legislature had high expectations of the group. He hoped that the final report would come out in a timely basis and that it would allow the Legislature to address the current problems that the State faces and wished the Committee well in its process. Chairman Hibbs thanked Senator Usdane and welcomed Senator Mawhinney to the Committee.

With no further business, the meeting was adjourned.

Respectfully Submitted,

Susanne M. Kufahl

Susanne M. Kufahl

CRITERIA FOR EVALUATING FISCAL SYSTEMS

A RESEARCH PAPER
PREPARED FOR
THE
ARIZONA JOINT SELECT COMMITTEE ON
STATE REVENUES AND EXPENDITURES

January 25, 1989

CRITERIA FOR EVALUATING FISCAL SYSTEMS
Executive Summary

State and local fiscal systems seem to be riddled with complexities, inefficiencies and inequities. Complexity is a problem because a misunderstood system does not well address the needs of the people the system was devised to serve. Inefficiency is related to waste - the size of the economic pie is smaller than perhaps it need be. Inequity can arise from unequal treatment or from treatment that does not adequately account for differences in economic circumstances.

Several criteria for evaluating a fiscal system can be identified. Below nine potentially useful criteria are briefly defined. The purpose of attempting to define a set of criteria is to provide a common, general framework that policymakers can refer to when policy options are considered. It is legitimate to ask of any potential aspect of the current fiscal system or any change to the system, what the effect is on the overall simplicity, fairness, equity, stability, efficiency, responsiveness, competitiveness, neutrality, and accountability of the system.

SIMPLICITY: Minimize fiscal compliance and administration costs. The system should be easily understood by affected individuals and businesses, and easily implemented by government agencies.

HORIZONTAL EQUITY: Treat individuals of equal means equally under the fiscal system.

VERTICAL EQUITY: Tax individuals with greater means or ability to pay more, or provide these individuals with fewer benefits from publicly provided goods and services.

EFFICIENCY: Employ benefit taxation where appropriate, and tax activity with relatively inelastic supply or demand relatively heavily.

NEUTRALITY: Avoid differential treatment of like economic activities.

STABILITY: Employ a system that does not produce wide cyclical swings in expenditures or revenues.

RESPONSIVENESS: Employ a system that adequately tracks the secular changes in the State's economy and population.

COMPETITIVENESS: Design the fiscal system so that it does not deter economic growth and prosperity.

ACCOUNTABILITY: Provide links between revenue raising responsibility and spending requirements and authority.

CRITERIA FOR EVALUATING FISCAL SYSTEMS

The purpose of defining a set of criteria for the Committee is to provide a common, general framework that members can refer to when policy options are considered. In general, criteria are used to evaluate revenue-neutral and expenditure-neutral changes to the fiscal system. Criteria aid in identifying structural deficiencies of the system such as unresponsiveness, unfair treatment, high costs of compliance, and detrimental effects on economic growth.

With its fiscal system, a state attempts to provide a desired level of goods and services and to finance adequately that chosen level. Economics can provide some guidance in the choice over the set and level of goods and services to provide. Three commonly accepted justifications for government provision of goods and services are (1) benefits being realized by those other than the individuals immediately involved (e.g., primary and secondary schooling), (2) nonrival and nonexclusionary consumption (e.g., a street light), and (3) a community's desires for some redistribution of resources. But these guidelines can take policymakers only so far. It is difficult to quantify the extent of external benefits and nonrival, nonexclusionary consumption, and preferences over redistribution are difficult to aggregate. At the margin the extent or size of government is a political decision that in a well-working democracy reflects the desires of the electorate.

However, three important criteria - simplicity, equity, and efficiency - do provide much guidance for evaluation and reform of a fiscal system. Efficiency has at least three aspects relevant for fiscal system evaluation. One aspect recognizes the fact that when individuals decrease their consumption of a good or cut back production in response to a tax, the associated consumer benefits and/or economic profits are lost. This is inefficient, since, without the tax, consumers were willing to pay at least the cost of producing those units and thus the exchange of units results in a net gain to society.

This discussion suggests that goods with unresponsive demands or supplies should be disproportionately taxed while those with very elastic demands or supplies should be taxed relatively lightly. This efficiency argument applies to taxing cigarettes, for example, since the demand for cigarettes is relatively price unresponsive. (Note that this rationale for taxing cigarettes differs from a commonly heard, and inconsistent rationale that cigarettes are demerit goods, the consumption of which should be discouraged, possibly through heavy taxation.) Of course, other less common taxes are also justified under this argument, such as a tax beyond a license fee on marriage, a consumer service that is likely to be quite price inelastic. To achieve efficiency, the simple rule of thumb is, when possible, to tax relatively lightly those economic activities that are relatively price responsive, and tax relatively heavily those economic activities that are price inelastic.

A third example will illustrate an important tradeoff that confronts tax policymakers over and over. One good with a very inelastic demand, and thus one that by the efficiency criterion should be taxed relatively heavily, is the drug insulin. However, a high tax and resulting high price for insulin strikes most people as a very unfair policy. This is a relatively easy efficiency/equity tradeoff to resolve, but others, with more problematic solutions, often arise in the design of an acceptable fiscal system.

A second, slightly different twist on the same efficiency concept is that, in an economy characterized by competitive markets and no market failures, taxes should be chosen to minimize distortions to economic behavior. As an example, when business taxes are designed to treat different types of inputs or different forms of capital differentially, decisions about the mix of inputs are distorted from their cost minimizing mix, that is, an inefficiency is generated. Sometimes this distortionary treatment can be justified as serving some other goal, such as encouraging a particular local or ailing industry, but the efficiency loss to society needs to be recognized.

The assumption that markets are perfectly competitive and without failure is critical to the above. If, for example, the use of one type of input, an input deemed the most cost effective by the business, imposes costs on other businesses or consumers not borne by the original business, then a tax on the use of the externality-generating input is efficient.

A final efficiency concept that provides an important link between taxes and the goods and services provided by government is the concept of benefit taxation. Under benefit taxation (also known as user charges) an individual must pay a price or tax per unit of the good or service consumed. Thus, individuals will choose not to use the publicly provided good or service if the benefits are less than the cost of getting access, and only those who benefit at least as much as the cost will use the good or service. This is an efficient allocation of the scarce resource.

For benefit taxation to be viable, certain characteristics must exist. It must be relatively inexpensive to exclude those who do not pay from the benefits of using the publicly provided good. So, for example, toll bridges are common whereas tolls to enter a Central Business District (CBD) network are not common, because the cost of monitoring every entrance to the CBD is prohibitively costly. Secondly, the good being provided cannot be of a redistributive nature or a good deemed necessary, regardless of ability to pay for the good. In these situations, the efficiency argument is at odds with equity considerations, illustrating the equity/efficiency tradeoff once again.

In summary, the efficiency criterion argues for taxing relatively inelastic goods and services relatively heavily, for using the fiscal system to distort economic decisions only when market failures are identified, and for using benefit taxation where appropriate. Several conflicts with a second important criterion, equity or fairness, have already been identified. There are two commonly used concepts of equity - horizontal equity and vertical equity.

Horizontal equity refers simply to the equal treatment of equals. If two individuals of equal income or wealth are treated differentially by the fiscal system, in terms of tax liability or services received, the system is characterized by horizontal inequity. This concept was one of the more important driving forces for tax reform at the federal level. There was a strong perception backed by reasonably strong evidence that taxpayers of equal tax paying ability were given differential treatment under the law based on how they earned or spent their income. While intuitively appealing, the concept of horizontal equity is surprisingly difficult to define accurately or to make operational. For example, one could argue that although different forms of income or consumption may be treated differentially under an income tax, each taxpayer is subject to the same tax system and is free to take advantage of as many loopholes and special treatments as the next taxpayer. In reality, the frustration with the federal income tax was more that certain forms of preferential treatment were only available to the wealthy, which brings us to the second form of equity.

Vertical equity refers to tax liability and expenditure benefits being related to economic well being or ability to pay. The idea is that those with a greater ability to pay taxes should pay more, and those with lesser ability to obtain necessary goods and services should receive more via public programs. Like horizontal equity, this concept is more subtle than it first appears. Although we may all agree that individuals of greater ability to pay should pay more in taxes and that individuals with less income or wealth should receive more in publicly provided goods and services, how much more is difficult to answer. Economics does not provide much guidance on this all important issue.

One guideline for tax policymakers that comes from this discussion of equity and efficiency is to employ benefit taxation where the circumstances warrant, and to employ ability-to-pay taxation for redistribution and for financing general government expenditures or government expenditures where it is difficult or undesirable to ration the scarce good or service via a tax price system.

Simplicity in a fiscal system requires more than ease of compliance and administration. When it is difficult to determine one's own tax liability or eligibility and benefits of a government program, confidence and trust in public officials and the "system" erodes. Government that obfuscates, that ignores real costs associated with unnecessary complexity, is an unresponsive government.

Some aspects of a state and local fiscal system are inherently complex. The complexity is a necessary evil of performing an otherwise worthy function. Yet, it is often the case that many goals of complex programs can be achieved through simpler means. For example, state personal income taxes are a common method of raising general revenue on an ability-to-pay basis. Attempts are often made to use the personal income tax to accomplish many more goals than equitable revenue raising. When special provisions are put into a state tax code to encourage certain types of economic behavior, they are likely to be ineffective (because state marginal tax rates are low relative to federal marginal tax rates) and to create complexity and costs of compliance and administration. A strong simplicity argument can be made for tying a state income tax base closely to the federal income tax base, and allowing for differing state preferences over vertical equity to be reflected in tax <u>rates</u> which are simple to implement and comply with.

Transfer payment programs are also often exceedingly complex. Again, the complexity may be inherent to a properly designed program. But a search for simpler yet equally effective programs can make for a more acceptable fiscal system.

Simplicity, equity and efficiency are three important criteria for evaluating fiscal systems. Several other criteria are also important to consider. <u>Stability</u> of the fiscal system is particularly important at the state level where constitutional or statutorial requirements for balanced budgets are ubiquitous. This concept, like the others, is more subtle than first appearances would lead one to believe. For example, a system that is stable over the business cycle may also be unresponsive to secular growth of the economy, which may or may not be desirable. Stability and <u>responsiveness</u> of the system to economic growth are related concepts that provide different attributes to a fiscal system.

Neutrality in a fiscal system can be confused with horizontal equity, but it is closer to an efficiency concept. Neutrality refers to an equal playing field, not giving an unfair advantage to one particular industry, firm, or activity. It can be invoked when discussing the property tax treatment of different types of commercial/industrial property, when discussing the sales tax treatment of different types of retail sales activity, and when discussing eligibility requirements for government programs that treat seemingly similar situations differentially.

A concept very closely related to efficiency and that links taxes and expenditures is accountability. Accountability refers to tying revenue raising responsibility to spending authority. A state and local fiscal system often scores poorly on this criterion when the state government becomes heavily involved financially or statutorily in the fiscal affairs of its local governments. The state involvement is often motivated by equity concerns and thus we have another illustration of the tradeoff between equity and efficiency. Comparative economic analysis can provide some guidance on preferred methods of intergovernmental fiscal relations.

Another concept also related to one aspect of efficiency is competitiveness or concern about economic development. State economies are open economies and if a state and local fiscal system is deficient in significant ways, from either the revenue or expenditure side, then people and businesses may feel compelled to move out of the state, or if choosing among several states for a desirable living and working environment, may choose another state. Many other characteristics about states are likely to be more powerful factors in these location decisions, but a fiscal system far out of line can make a difference.

In summary, several criteria for evaluating a fiscal system have been identified and discussed. The purpose of attempting to define a set of criteria is to provide a common, general framework that policymakers can refer to when policy options are considered. It is legitimate to ask of any potential aspect of the current fiscal system or any change to the system, what the effect is on the overall simplicity, fairness, efficiency, neutrality, stability, responsiveness, competitiveness, and accountability of the system.

SIMPLICITY: Minimize fiscal compliance and administration costs. The system should be easily understood by affected individuals and businesses, and easily implemented by government agencies.

HORIZONTAL EQUITY: Treat individuals of equal means equally under the fiscal system.

VERTICAL EQUITY: Tax individuals with greater means or ability to pay more, or provide these individuals with fewer benefits from publicly provided goods and services.

EFFICIENCY: Employ benefit taxation where appropriate, and tax activity with relatively inelastic supply or demand relatively heavily.

NEUTRALITY: Avoid differential treatment of like economic activities.

STABILITY: Employ a system that does not produce wide cyclical swings in expenditures or revenues.

RESPONSIVENESS: Employ a system that adequately tracks the secular changes in the State's economy and population.

COMPETITIVENESS: Design the fiscal system so that it does not deter economic growth and prosperity.

ACCOUNTABILITY: Provide links between revenue raising responsibility and spending requirements and authority.

INTERSTATE FISCAL COMPARISONS

A RESEARCH PAPER
PREPARED FOR
THE
ARIZONA JOINT SELECT COMMITTEE ON
STATE REVENUES AND EXPENDITURES

January 25, 1989

INTERSTATE FISCAL COMPARISONS
Executive Summary

The public budget--the total set of state and local government tax and expenditure policies--forms a primary tool for accomplishing governmental goals. Since states operate in open economies that are affected by external policies and circumstances, it is useful to compare Arizona's fiscal system with the systems in other states.

Such comparisons highlight Arizona's basic fiscal structure in the context of the larger regional and national economies, and may provide initial indicators of fiscal imbalances. Interstate fiscal comparisons do not, however, illustrate whether revenue and expenditure levels are too high or too low, since states differ greatly in demographic characteristics and in political preferences. Likewise, interstate comparisons alone can not measure a state's economic competitiveness because many factors other than taxes and spending may be related to economic growth.

This research paper relies on U.S. Census data for the period between 1975 and 1987. Comparisons are made between Arizona, the national average, and ten other states selected for their economic competition with Arizona or their similarities or great differences with Arizona's fiscal system. All figures include aggregates of state and local data.

Expenditures

Arizona expenditures as a percentage of state personal income have remained nearly constant over the period reviewed, while the expenditure to personal income ratios of most of the comparison states, and the national average, have fallen slightly. In FY 1986, Arizona's ratio of expenditures to personal income was 20.7 percent, 13 percent above the U.S. average of 18.3 percent, and Arizona ranked fifth among the eleven comparison states.

For FY 1986, Arizona's per capita expenditures were about average for elementary and secondary education, above average for higher education, highways and police and fire, and lower than average for public welfare and health and hospitals. Using a representative expenditure system index for FY 1987, which takes account of the underlying need for certain types of expenditures, Arizona spent over 40 percent less than its representative need level for welfare and health, and over 35 percent more than its representative need for higher education, highways, and police and corrections.

Revenues

Taking account of changes in population and personal income, Arizona's revenues grew at about the national average rate between 1975 and 1987. Since 1975, Arizona's revenues per capita have remained slightly below the national average (98 percent of average in FY 1987). During that same period, Arizona's revenues relative to personal income ranged from seven to eleven percent above the national average, and, in 1987, Arizona ranked fifth among the comparison states.

Using FY 1987 data, Arizona's state/local breakdown of total revenue was about average. However, Arizona raised 24 percent of total revenues through state and local general sales taxes, compared to a national average of 17 percent, and raised 12 percent of its revenues from income taxes compared to a 17 percent average.

Using a representative tax system index, Arizona's total tax base capacity increased from 92 percent of average to 99 percent of average between 1975 and 1986, and Arizona ranked eighth among the comparison states in 1986.

In FY 1986, Arizona's tax effort relative to capacity varied tax by tax. The tax effort on the sales tax base was 53 percent above average, ranking second in the nation. Tax efforts on selective sales and license fees were about average, whereas the efforts on the individual income tax, property tax, corporate income tax, mineral tax and user charge bases were below average.

In summary, Arizona is an average state in many fiscal respects. Despite rapid population growth, Arizona has remained very close to the national average in revenue growth per capita and per dollar personal income and in overall tax capacity and tax effort. Arizona is somewhat above the national average in expenditures as a percentage of personal income and in revenue as a percentage of personal income. Arizona also differs from the national average in its mix of taxes and its composition of expenditures. As the Committee proceeds with its study of specific taxes and spending programs, the interaction of economic competitiveness and fiscal efficiency, equity, simplicity and accountability will be explored in greater depth.

'75 to '87

INTERSTATE FISCAL COMPARISONS

INTRODUCTION

Purpose and Scope

Like the other forty-nine states and the District of Columbia, Arizona operates in an "open economy." That is, it is generally not free to establish any legal or institutional barriers to the movement of commodities and/or resources (e.g., labor, capital) across its borders. Thus, for example, Arizona cannot establish tariff barriers or migration controls in order to shape its economic, social, and demographic environment.

What Arizonans can do, however, is to influence the character of the State by establishing state and local government programs. And the primary (though by no means the only) tool for accomplishing governmental goals is the public budget--that is, the set of state and local government tax and expenditure policies.

But, because of the openness of the U.S. economy, even these "own state" tax and expenditure arrangements cannot be made without regard to the nature of the budget policies of the other states. As a result, a question that inevitably arises with respect to state and local fiscal policies is: How does our state (e.g., Arizona) compare with the others--in terms of the mix and level of public goods and services provided and the tools that are used to pay for those activities.

The question of how Arizona compares is useful for describing the State's basic fiscal structure and for viewing that structure in the context of the larger regional and national economies. Interstate comparisons are also useful for taking a first glance at the issue of economic competitiveness.

The relevance of interstate fiscal comparisons to Arizona's economic competitiveness derives from the openness of state economies--the budget is one of the few economic development factors over which policy makers have significant policy control. Thus, for example, although there may be little (if anything) legislators can do about Phoenix's hot summers to expand the local employment base, they may be able to directly influence certain job creation decisions (negatively as well as positively) through their budget actions. Accordingly, policy-makers will often want to know if tax burdens are higher or lower in this State than in others, or if government spending on certain programs is higher or lower, or if other of the State's policies are "out of line" with those of competing jurisdictions. The interstate comparison is one way to begin to address that question. And fiscal comparisons have, in fact, become increasingly important during the 1980's. Federal grants in aid to states and localities have diminished, and the federal deductibility of state and local taxes has been reduced, both decreasing the fiscal equalization effect across states and highlighting state-to-state differences.

In short, interstate fiscal comparisons are an appropriate element of the study and understanding of the Arizona fiscal system. But it is important to note that fiscal comparisons form only the first step in evaluating any state's economic competitiveness. Interstate differences in demographic characteristics or industrial structure may make it perfectly logical and beneficial for one state to set fiscal policies that are very different from another state's. So, while significant interstate differences may be initial indicators of a fiscal imbalance, additional information and evidence about economic competitiveness are needed before conclusions and policy decisions are made.

It is important to explore economic competitiveness in more depth since it is often the case that below-average taxes and spending are presented as "evidence" of a state's favorable "business climate." Indeed, such numbers may reveal just the opposite: that public services are inadequate for attracting business to an area. Similarly, a state ranking above other states in its spending/taxing record does not necessarily show that its services are being provided in a manner that effectively makes a location favorable to job development and/or the in-migration of skilled laborers.

The Data

The methodology used in fiscal comparisons involves selecting a set of indicators that are common to the all the states and then comparing their levels and trends for a set of years. It is also useful to relate these indicators for one state (e.g., Arizona) to a group of other states in order to illustrate relative differences.

Indicators In order to make meaningful interstate fiscal comparisons, it is essential to apply consistent definitions and measurements across all states. Accordingly, one must rely on information compiled by the U.S. Bureau of the Census, which collects and then reports data in uniform fashion with the express purpose of facilitating comparisons across jurisdictions. One cannot rely directly on internal state budget documents or other financial reports for deriving interstate comparisons, because the definition of taxes and expenditures will vary across the states.

On the expenditure side of the budget, for example, medical aid to the poor may be categorized as spending on "health" services in one state but as a component of "welfare" in another. Similar types of discrepancies occur on the receipts side of the budget. Some states that impose gross receipts taxes on business activities may consider the tax to be in the nature of an income tax levy, while others treat it as part of their sales tax collections.

The same type of problem arises with respect to what is a state versus a local tax and/or expenditure. Different states allocate structurally similar taxes (and non-tax revenues) and expenditures to different levels of government. Thus, what Arizona may consider a local responsibility in its highway or education system may be treated as a state function in Texas. And in some places the sales tax may be only available for state use (e.g, Hawaii), whereas in other states the tax may be considered primarily a source of local revenues (Nevada). Again it is necessary to use a consistent frame of reference for making fiscal comparisons. Consistency requires both utilizing Census data and also reporting comparisons in terms of the <u>sum of state and local aggregates.</u> To do otherwise could lead one to draw conclusions about incomparable numbers.

<u>Years</u> Because of the need to adjust data to ensure consistency, the published Census data lags the end of the fiscal year by about eighteen months. Thus, the most recent data available for most of the discussion that follows is for 1986. This data lag does not present a major problem when one is interested in comparing expenditure and tax levels among the states. In making interstate comparisons one wants to learn about gradual and/or continuous changes over time--not the single snapshot situations that may reflect actions designed to meet unusual or unexpected one-time budgetary requirements. Accordingly, much of the following data is presented over an eleven to twelve year

period beginning in 1975 (representative of the end of the era of rising federal aid flows to the states), continuing with 1980 (which generally dates the period of the state "tax revolts"), and then 1985 and 1986 or 1987 (the most recent years for which data are available).

The Comparison States In order to highlight certain aspects of Arizona's fiscal place among the states, comparisons are made between Arizona, the U.S. average, and ten other states. Colorado, California, Nevada, New Mexico and Utah are included because they are geographically neighboring states which are seen to compete with Arizona for residents and/or jobs. Florida and Texas are included because their economies also compete with Arizona for industry-specific resources (tourism in Florida and high-technology in Texas). Illinois, and New York--although having fiscal structures very different from Arizona's--also compete with Arizona for residents (in the late 1970's the greatest percentages of migrants to Arizona came from these two states and California). Finally, Minnesota is included because its economy and fiscal structure are quite different from Arizona's, and these differences can provide interesting perspectives and insights.

EXPENDITURES

It is appropriate to begin the examination of the Arizona fiscal system by first taking a look at the expenditure side of the budget.

There are two reasons for doing so. First, and fundamentally, governments tax to spend. That is, over time, the level of revenues will reflect the desired level of spending. Second, the very structure of the revenue system may reflect spending behavior as well as taxing philosophies. If government expenditures rise and fall at erratic rates, for example, the legislature may resort to a series of uncoordinated revenue adjustments to address short-term financial needs rather than the long-run fiscal goals of the state. Thus, spending patterns may provide insight about the revenue-raising structure.

Level and Composition of Expenditures

Two conventional measures of interstate spending comparisons are presented below. Table 1 compares Arizona's direct expenditures (all spending other than intergovernmental, utility, and insurance trust spending) both in dollars and as a percent of personal income. By dividing spending by a readily available common denominator such as state personal income, one can make both intertemporal and interjurisdictional comparisons.

Table 1

STATE AND LOCAL DIRECT GENERAL EXPENDITURES AS A PERCENTAGE OF STATE PERSONAL INCOME
SELECTED FISCAL YEARS 1975–1986

State	1986 Total Direct Expenditure (in millions)	1986 As a % of Personal Income	1986 Index*	1985 Total Direct Expenditure (in millions)	1985 As a % of Personal Income	1985 Index*	1980 Total Direct Expenditure (in millions)	1980 As a % of Personal Income	1980 Index*	1975 Total Direct Expenditure (in millions)	1975 As a % of Personal Income	1975 Index*	
United States	$604,455.4	18.3%	100	$552,197.5	18.3%	100	$367,339.9	19.0%	100	$229,474.0	19.9%	100	
ARIZONA	8,428.9	20.7	113	7,345.0	20.3	111	4,204.7	20.4	107	2,288.7	20.7	104	4% above average
California	76,082.3	18.0	98	68,428.9	18.4	101	43,412.7	19.0	100	26,703.8	21.2	107	
Colorado	8,387.8	17.5	96	7,817.4	17.8	97	4,558.4	18.0	95	2,837.6	20.6	104	
Florida	24,790.1	15.9	87	22,227.7	15.9	87	12,753.7	16.8	88	7,885.2	18.0	90	
Illinois	27,155.0	16.0	87	25,066.8	15.8	86	18,122.1	16.5	87	11,875.2	17.1	86	
Minnesota	12,846.6	21.7	119	11,918.4	21.6	118	7,723.6	21.5	113	4,707.4	22.2	112	
Nevada	2,564.3	18.9	103	2,355.3	19.4	106	1,491.9	20.2	106	767.3	22.3	112	
New Mexico	3,987.7	25.2	138	3,677.7	25.2	138	2,156.0	23.0	121	1,144.5	24.7	124	
New York	64,256.5	22.5	123	59,454.9	23.4	128	38,689.9	24.1	127	29,193.8	26.2	132	
Texas	36,760.2	16.7	91	32,803.1	16.3	89	19,376.0	16.5	87	10,255.1	17.2	86	
Utah	4,132.9	23.9	131	3,827.2	23.8	130	2,359.0	24.0	126	1,159.7	22.1	111	

*100.0 = U.S. Average
Source: ACIR staff computations using ACIR State-Local Finance Diskettes for FY86 and 85.
Governmental Finances in 1974-75 and 1979-80.

— AZ personal income capacity is below average
— so we need to spend more to provide a same package of services

As the data shows, Arizona's expenditures as a percent of personal income have remained relatively constant over time; but relative to the national average of the fifty states and the District of Columbia, Arizona's expenditures have been slowly and steadily rising. This has occurred because the national average expenditures have been falling. The record of the comparison states is mixed: California and Nevada have exhibited declines in the relative level of direct expenditures to state personal income between 1975 and 1986, while Utah, New Mexico, Minnesota, and New York have maintained a relatively high level of spending activity. Florida, Colorado, and Illinois have exhibited little change in their expenditure to personal income ratios. And the Texas ratio, while still below average in 1986, has steadily increased relative to the U.S. average.

Table 2 presents information regarding a second measure of expenditures, per capita expenditures and state and local government expenditures broken out by functional composition. As that table shows, in per capita terms Arizona is about average in total spending and spending on elementary and secondary education; above average for higher education, highways, and police and fire; and well below the national norm for expenditures on welfare and health and hospitals. It is important to note that while per capita terms are used for consistent comparisons here, other ratios may be more relevant for certain types of spending. Expenditures per pupil, for example, may reveal more about the true level of education spending than per capita measures.

Table 2
PER CAPITA SPENDING AND PERCENTAGE DISTRIBUTION AMONG
EXPENDITURE FUNCTIONS, SELECTED STATES, 1986

State	Exhibit: 1986 Total Direct Expenditure	Elem & Sec Education Direct	(a)	Higher Education Direct	(a)	Public Welfare Direct	(a)	Health & Hospitals	(a)	Direct Highways	(a)	Direct Police & Fire	(a)	Other	(a)	Total Per Capita	Index(b)
United States	$604,455	$602	24.0%	$235	9.4%	$310	12.3%	$222	8.9%	$205	8.2%	$134	5.3%	$800	31.9%	$2,507	100
ARIZONA	8,429	634	25.0	323	12.7	182	7.2	124	4.9	275	10.8	156	6.2	846	33.3	2,541	101
California	76,082	587	20.8	288	10.2	387	13.7	251	8.9	127	4.5	187	6.6	992	35.2	2,820	112
Colorado	8,388	667	26.0	264	10.3	250	9.7	202	7.9	246	9.6	145	5.6	794	30.9	2,567	102
Florida	24,790	524	24.7	133	6.3	157	7.4	229	10.8	163	7.7	153	7.2	765	36.0	2,123	85
Illinois	27,155	546	23.2	207	8.8	330	14.0	152	6.5	208	8.8	150	6.4	758	32.3	2,350	94
Minnesota	12,847	703	23.1	260	8.5	459	15.1	245	8.0	311	10.2	110	3.6	960	31.5	3,049	122
Nevada	2,564	550	20.6	198	7.4	152	5.7	184	6.9	289	10.9	211	7.9	1,079	40.5	2,663	106
New Mexico	3,988	673	25.0	366	13.6	197	7.3	205	7.6	290	10.7	121	4.5	845	31.3	2,696	108
New York	64,257	787	21.8	195	5.4	625	17.3	362	10.0	202	5.6	201	5.6	1,243	34.4	3,616	144
Texas	36,760	650	29.5	260	11.8	141	6.4	190	8.6	230	10.4	110	5.0	623	28.3	2,204	88
Utah	4,133	659	26.5	353	14.2	214	8.6	174	7.0	249	10.0	110	4.4	724	29.2	2,482	99

Source: ACIR staff computations using ACIR State-Local Government Finance Diskettes, FY86.
(a) Figures in these columns indicate percentage of direct total expenditure
(b) 100 = U.S. Average

expenditure per capita

above $\left\{ \begin{array}{l} \text{highways} \\ \text{Universities} \\ \text{police \& fire} \end{array} \right.$

25 K-12
13 Universities
11 Hiways

Many quick comparisons among the selected states can be made. For example, most of the comparison states are at or near the average level of education spending (with only California and Nevada being noticeably below average). Six of the ten comparison states are, like Arizona, well below the U.S. average for welfare spending. Arizona had the second highest expenditure percentage on highways of the illustrated states, and the lowest percentage of the eleven for health and hospitals.

Table 2A shows the functional distribution of per capita Arizona expenditures between 1980 and 1987. Over that time period, the percentage of total dollars spent on education, health, and administration decreased, while the percentage spent on highways, welfare and interest increased.

What can one conclude from these data? The answer is: not a whole lot. As noted above, there is nothing in these comparisons that tells us whether Arizona is spending at "too high" or "too low" a level, either as measured by changes in the level of expenditures over time or in terms of their composition. The numbers do, however, suggest some interesting questions for further examination in the remainder of the Committee's work: What explains the relatively high and rising level of expenditures over time? Are Arizonans' preferences for public goods and services increasing as their incomes increase? Does the growth in expenditure levels over the past decade reflect a need for Arizona governments to increase public services in order to accommodate the State's rapid economic growth over the same time period? If so, is

Table 3

ACTUAL DIRECT GENERAL EXPENDITURES BY STATE AND LOCAL GOVERNMENTS IN SELECTED STATES AS PERCENTAGES OF REPRESENTATIVE EXPENDITURES, BY FUNCTION, FISCAL YEARS 1986-87

State	Total	Education: Primary & Secondary	Education: Higher	Public Welfare	Health and Hospitals	Highways	Police and Corrections	All Other Expenditures
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
United States	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
ARIZONA	100.6	103.3	139.2	58.8	50.6	150.1	139.0	98.3
California	115.8	103.4	122.6	130.4	116.3	71.6	137.6	123.0
Colorado	107.8	112.0	114.9	100.7	96.2	105.7	115.4	107.1
Florida	90.7	105.2	59.3	49.6	98.7	89.4	106.7	101.2
Illinois	96.2	92.8	92.5	103.1	70.6	125.4	93.5	98.3
Minnesota	126.3	120.2	135.5	171.7	124.1	120.7	99.8	119.4
Nevada	108.2	93.1	80.7	67.0	91.0	106.2	151.6	135.4
New Mexico	86.1	86.1	119.4	44.9	74.5	104.6	89.6	96.2
New York	153.4	150.9	87.7	198.3	174.3	154.0	145.7	153.2
Texas	80.1	87.5	103.2	42.4	80.7	98.0	68.1	80.6
Utah	88.3	68.7	152.1	81.8	83.2	98.6	103.4	89.4

Sources: U.S. Bureau of the Census, Government Finances in 1986-87, GF-87-5 (November 1988), Table 29; unpublished estimates by Robert W. Rafuse, Jr., Visiting Senior Fellow, ACIR (1989).

there reason to expect the Arizona to U.S. ratio (Table 1) to converge rather than to widen as the State's economy enters the next decade? What explains the unusually low amount of public resources being allocated to welfare and health? Is this because Arizona policy-makers are reflecting a voter preference against resource redistribution? Or, might these numbers be explained by the fact that Arizona is not as densely populated as much of the rest of the country, and/or that people who live and work here are healthier and simply better able to care for their own social needs? Why are per capita expenditures on education and highways on the high end of the spectrum? Is the school-aged population as a percentage of total population high relative to other states, requiring more education spending? Have our highway expenditures lagged behind other states, with construction programs peaking in the mid-1980's? These types of questions can be explored as the Committee continues its work throughout the spring and summer.

The Representative State Expenditure System

A new approach to the comparative analysis of state and local government expenditures offers some insights into these questions about Arizona's spending for specific types of programs. The approach involves the calculation of "representative expenditures." A state's representative expenditure for a program function is the level it would have to undertake in order to match the national average level of spending in relation to the underlying need for the service.

The representative expenditure approach was developed during the U.S. Treasury Department's studies of federal-state-local fiscal relations several years ago. Estimates of representative expenditures for eight major categories of public spending originally published in the Treasury report for 1984 have recently been refined and updated to 1987.

The essential idea behind the representative expenditure calculation is that the "need" for spending on a particular function in a state can be related to a "workload" measure. The workload measure is a simple index comparing the level of some relevant characteristics in a state to the level in the nation as a whole. In the case of public welfare, for example, the workload measure is a state's proportion of the total U.S. population living in households with incomes below the poverty line. In the case of higher education, the workload measure is more complicated: it is the weighted sum of a state's proportion of total U.S. population in various age groups. Given these workload measures, which all are expressed as proportions of a U.S. total, a state's representative expenditure for a function is the equivalent proportion of the actual total spending for the function by all state and local governments in the country.

For example, because Arizona contained a greater than average proportion of low income population in 1987, the representative per capita welfare expenditure is greater than the U.S. average. In actuality, Arizona spent a below-average amount per capita on welfare. The actual per capita expenditures were only 58.8 percent of the representative need for expenditures. In the case of higher education, Arizona's representative level of need is slightly lower per capita than the U.S. average, while actual 1987 per capita expenditures were higher than average. Arizona actual per capita expenditures on higher education were 39.2 percent above the representative need.

The results in Table 3 show that Arizona's total expenditures were approximately equal to its total representative expenditures. The general picture repeats the results of Table 2, showing Arizona with relatively low expenditures relative to need on welfare and health and hospitals, and relatively high expenditures on education, highways, and police protection. The percentage comparisons, however, differ from the results in Table 2 that do not consider a measure of need. When need is included, the magnitudes change so that Arizona's high levels of spending appear even higher, and the low levels appear lower. The results illustrate dramatic differences between actual expenditures and representative expenditures for most of the expenditure categories. The rank order among the illustrated states shifts somewhat as well.

Table 2A
Arizona Per Capita State and Local, Direct General Expenditures
and Percent Distribution by Functional Category, Selected Years

Function	1980		1985		1987	
	Per Capita	Percent	Per Capita	Percent	Per Capita	Percent
Education	$673	43.5%	$872	37.8%	$1,071	38.2%
Highways	157	10.2	243	10.5	364	13.0
Public Welfare	68	4.4	181	7.9	215	7.7
Health & Hospital	110	7.1	109	4.7	126	4.5
Police & Fire	102	6.6	150	6.5	172	6.1
Sewerage & Sanitation	54	3.5	86	3.7	78	2.8
Local Parks & Recreations	70	4.5	98	4.3	122	4.4
Financial Administration and General Control	78	5.0	96	4.2	117	4.2
Interest on General Debt	45	2.9	163	7.1	196	7.0
Other Expenditure	191	12.3	307	13.3	342	12.2
Total	1547	100.0	2305	100.0	2803	100.0

Source: U.S. Bureau of the Census, Governmental Finances, various years.
Note: Expenditures are in current dollars; percent details may not add to 100.0 due to rounding.
*For 1985 and 1987, Local Parks and Recreation adds in spending for natural resources."

REVENUES

Economists use several tax and tax-related measures as indicators of fiscal performance. In general, these indicators rely on four basic estimates: population, personal income, size of tax base, and tax and revenue collections. The first three of these indicators provide common denominators for comparison. The tax and revenue aggregates serve as numerators.

As with any aggregate measure of fiscal performance, the tax and revenue indicators discussed here have advantages and disadvantages, and the significance of these merits and shortcomings varies depending on the specific indicator being used. However, at least two observations pertain to all of the following measures.

The first is that their usefulness derives largely from the fact that they provide a quick and consistent method for comparison. In practice, there is much more consistency across states as to what constitutes a given tax or tax base than there is regarding what is an appropriate public expenditure.

A second and equally important merit of aggregate indicators of interstate fiscal variation is their ease of calculation and, thus, their familiarity to a wide range of citizen groups.

At the same time, however, such interstate tax and revenue comparisons are characterized by several inherent limitations and therefore should be interpreted with care:

A. Interstate comparisons based on collections do not take into account variation in the scope, quality, or cost of public services provided in each state. It may be that differences in tax burdens across states represent varying levels of services provided, not only varying tax policies.

B. The estimates on which the measures are based are assumed to be independent of each other, ignoring the possibility that they may interact. For example, tax rates may influence the size of the tax base, or some of the income being taxed may itself have been created by the public sector.

C. The use of aggregate measures gives no indication of the incidence of tax burdens--how the tax burden is distributed among, for example, income classes or different types of taxpayers such as residents and nonresidents.

D. The estimates for any particular year may not be representative. For example, a state's tax revenues in a particular year could reflect a revenue windfall or shortfall, or a temporary tax surcharge.

It is important to keep these warnings in mind when making interstate comparisons of the sort presented here. Such tax burden measures do not tell the whole story about such concerns as taxpayer equity and business climate. However, because the same limitations apply to the data for each state, when viewed over time the comparisons can present a useful picture of how a specific state compares with others.

Overall Revenue Growth

Between 1975 and 1987, Arizona state and local government experienced extraordinary revenue growth. As shown in Table 4, Arizona's state-local own-source general revenues in 1987 were over four times their 1975 level. While Arizona's total revenue growth during this period was greater than that of any of the comparison states, several of the other states (including Utah, Florida, Texas, and New Mexico) also experienced high levels of revenue growth compared to the national average.

Knowing that a state's revenues have grown rapidly tells us little about the reasons for such growth or about the change in tax burdens in the state, however. Revenue increases may be due to changes in demographics, tax policy, economic conditions, or other factors which interact to affect tax yields.

TABLE 4
STATE-LOCAL GENERAL REVENUE FROM OWN SOURCES, SELECTED FISCAL YEARS 1975-1987
ARIZONA AND COMPARISON STATES
(in $millions)

	1975	1980	1985	1987	% Change 1975-87	Change as % of US Ave.	% Change in Population 1975-1987	% Change in Per Capita Personal Income 1974-1986
ARIZONA	1,855	3,559	6,384	7,763	418	133	52	263
Neighboring States								
California	22,687	36,577	60,016	75,620	333	106	31	280
Colorado	2,215	4,066	7,003	8,145	368	117	30	276
Nevada	627	1,147	2,097	2,414	385	122	70	257
New Mexico	922	1,960	3,436	3,673	398	126	31	276
Utah	837	1,704	3,375	3,472	415	131	39	245
Other Comparison States								
Florida	6,016	10,494	20,135	24,910	414	131	44	270
Illinois	9,821	15,312	22,429	25,126	256	81	1	250
Minnesota	3,909	6,451	10,935	12,342	316	100	8	276
New York	22,886	32,350	53,111	63,142	276	87	(2)	278
Texas	8,413	16,513	30,690	33,985	404	128	37	272
U.S. TOTAL	181,141	299,293	491,526	571,168	315	100	14	269

Source: Compilation based on U.S. Bureau of the Census, Government Finances, various issues.

Two obvious factors that affect overall revenue increases are population growth and personal income growth. A growing population will lead to increased tax revenues to the extent the newcomers are subject to taxes already in place. An increasing population will also require that a higher level of services be provided if per capita service levels are to be maintained; this increased demand for services will also necessitate higher revenues. Higher per capita personal income levels will increase revenues to the extent taxes are levied on income or uses of income, i.e. consumption. As income increases, demand for public goods and services may also increase, requiring higher revenues to support their provision.

The last two columns of Table 4 show how the two factors of population and income growth relate to the states' revenue growth. Arizona's population grew by 52 percent between 1975 and 1987, faster than any of the comparison states except Nevada, and almost four times faster than the national average of 14 percent. Per capita personal income, meanwhile, grew somewhat more slowly than the national average, changing 263 percent compared to the national average of 269 percent. Arizona's growth in personal income per capita was less than the growth in seven of the ten comparison states. While this lower-than-average per capita personal income growth would tend to reduce revenue growth over time, it appears that the dramatic increase in population overwhelmed the personal income effect and led to the relatively high level of revenue growth in Arizona.

Revenue Growth Per Capita and Per $1,000 Income

Tables 5 and 6 show revenue levels and growth on the basis of population and income, respectively. Putting the revenue data on a per capita basis allows more meaningful comparisons of states with differing population levels and rates of population growth. Adjusting for income also nets out effects of state size and growth.

Tables 5 and 6 show that when population and income growth are accounted for, Arizona's revenue growth was about average for the period between 1975 and 1987. The State's revenue per capita grew 275 percent over this period, just about the national average of 276 percent. The state's revenue per $1,000 income grew by the national average of three percent.

Level of Revenues

If Arizona's rate of revenue growth (accounting for population and income growth) is about average, how does its level of collections compare? Tables 5 and 6 also permit interstate comparison of revenue levels.

Revenues per capita One measure widely used to make interstate tax burden comparisons is the level of revenues per capita. By dividing collections by population, such measures provide a common denominator among states and account for different population levels. Per capita measures are easily computed and

TABLE 5
PER CAPITA STATE-LOCAL OWN-SOURCE GENERAL REVENUE, 1975-1987
ARIZONA AND COMPARISON STATES

	1975	% of U.S. Average	1980	% of U.S. Average	1985	% of U.S. Average	1987	% of U.S. Average	% Change 1975-87	Change as % of U.S. Ave.
ARIZONA	$834	98.1	$1,309	99.1	$2,003	97.3	$2,293	97.7	275	100
Neighboring States										
California	1071	126.0	1545	117.0	2276	110.6	2697	115.0	252	91
Colorado	874	102.9	1407	106.5	2167	105.3	2471	105.3	283	102
Nevada	1060	124.7	1436	108.7	2241	108.8	2397	102.1	226	82
New Mexico	804	94.6	1508	114.1	2370	115.1	2449	104.3	305	110
Utah	694	81.7	1166	88.2	2052	99.7	2066	88.1	298	108
Other Comparison States										
Florida	720	84.7	1077	81.5	1772	86.0	2072	88.3	288	104
Illinois	881	103.7	1341	101.5	1944	94.4	2169	92.4	246	89
Minnesota	996	117.1	1582	119.7	2608	126.7	2907	123.9	292	106
New York	1263	148.6	1843	139.4	2987	145.1	3542	151.0	280	102
Texas	688	80.9	1161	87.8	1875	91.1	2024	86.3	294	107
U.S. AVERAGE	850	100.0	1321	100.0	2059	100.0	2347	100.0	276	100

Source: Compilation based on U.S. Bureau of the Census, Government Finances, various issues.

TABLE 6
STATE-LOCAL OWN-SOURCE GENERAL REVENUE PER $1,000 PERSONAL INCOME, 1975-1987 ARIZONA AND COMPARISON STATES

	1975	% of U.S. Average	1980	% of U.S. Average	1985	% of U.S. Average	1987	% of U.S. Average	% Change 1975-87	Change as % of U.S. Ave.
ARIZONA	$168	106.8	$172	111.3	$177	108.5	$174	107.3	103	100
Neighboring States										
California	180	114.4	160	103.5	162	99.3	164	101.1	91	88
Colorado	161	102.3	161	103.7	159	97.8	164	101.1	102	99
Nevada	182	115.7	155	100.2	173	106.2	162	100.3	89	87
New Mexico	199	126.2	209	134.8	235	144.5	217	134.3	109	106
Utah	160	101.5	173	111.7	210	129.0	190	117.3	119	116
Other Comparison States										
Florida	137	87.3	139	89.4	144	88.3	146	90.0	106	103
Illinois	142	90.0	139	89.8	141	86.7	140	86.2	99	96
Minnesota	184	117.0	179	115.6	198	121.9	195	120.7	106	103
New York	205	130.4	201	129.9	209	128.5	208	128.3	101	98
Texas	141	89.6	140	90.6	153	93.8	151	93.4	107	104
U.S. AVERAGE	157	100.0	155	100.0	163	100.0	162	100.0	103	100

Source: Compilation based on U.S. Bureau of the Census, Government Finances, various issues.

have an intuitive appeal; they are, however, weak measures of tax burden.

Per capita measures treat all residents identically, regardless of their age, degree of economic dependence, taxpaying capability, or need for public services. For example, two states with the same level of collections and same number of residents but different mixes of retirees and workers would be measured as having the same tax burden, even though the states could be expected to have differing aggregate taxpaying capabilities and differing needs for public services. By dividing by the number of state <u>residents</u>, per capita measures also fail to account for the tax burden effects of revenue collections from non-residents (such as out-of-state workers, visitors, and consumers).

The data in Table 5 show that since 1975, Arizona has consistently been slightly below the national average (97 percent to 99 percent of the average) in collections per capita. In contrast, all of the state's geographical neighbors except Utah have been somewhat above average in total collections per capita. The two "economic neighbor" states of Florida and Texas have remained consistently below the U.S. average. And two of the comparison states, Minnesota and New York, show per capita collections well above average (24 percent and 51 percent above average, respectively, in 1987).

<u>Revenues per $1,000 income</u> State and local revenue in relation to personal income is a somewhat better measure of interstate burden variation than revenues per capita, because it

captures an element of differential taxpaying ability among states. By focusing on resident income, however, this measure (like revenues per capita) ignores tax exporting, the ability of a state to collect taxes from nonresidents. By failing to account for non-resident taxes, the ratio of revenues to income overstates the tax burden on the residents of energy-rich states such as Texas, or tourist-rich states, such as Nevada, that can significantly export taxes. By focusing on income, this measure also distorts the tax burden where various tax bases are changing at rates different from income. This is true, for example, in states experiencing economic decline reflected in declining property or sales tax bases. Since these sort of distortions apply to all states' revenue-income ratios to varying degrees, one should be cautious in drawing conclusions about tax burdens from the ratios shown.

Table 6 shows that Arizona's revenues per $1,000 personal income were between seven percent and 11 percent above the national average between 1975 and 1987. In 1987, three of the comparison states--California, Colorado, and Nevada--were within one percent of the national average on this measure, while Utah, New Mexico, Minnesota and New York were well above average. Considering that New Mexico and Utah have significant mineral wealth, their high ratios are probably due, at least in part, to tax exportation. And note the data for Texas, another state with significant tax exportation potential. Even though that state's revenue-income ratio is shown to be seven percent to 10 percent below average, this measure probably overstates the resident tax burden in Texas.

The above-average ratio for Arizona probably also overstates the resident burden, since Arizona can export some portion of the tax burden to non-residents through the mining and tourism industries.

Tax Mix

What is the relative contribution of various revenue sources to overall tax burdens? Table 7 presents data on how Arizona's revenue system compares with that of other states by showing the percentage composition of total state-local own-source revenues by major revenue source.

Table 7 presents a complicated picture. On the one hand, it shows the diversity of state-local tax systems, reflecting differing economic bases and political preferences. Nevada and Florida, for example, have very low or no state income taxes compared with most other states, but rely more heavily on sales taxes. Texas and New Mexico both have substantial severance tax revenues and low (or no) income taxes, but Texas relies more heavily than average on the local property tax whereas the opposite is true for New Mexico. New York, California, and Minnesota all rely heavily on the income tax.

On the other hand, the table shows considerable agreement among states in how they structure their intergovernmental tax systems. For example, in all of the comparison states except New Mexico, the state share of total state-local revenues is between

TABLE 7
PERCENTAGE COMPOSITION OF STATE-LOCAL OWN-SOURCE REVENUES, FY87
ARIZONA AND COMPARISON STATES

	STATE REVENUES						LOCAL REVENUES					
	All State Revenues	General Sales Tax	Income Taxes	Severance Taxes	All Other Taxes	Charges & Miscell. Revenues	All Local Revenues	Property Taxes	General Sales Tax	All Other Taxes	Charges & Miscell. Revenues	TOTAL GENERAL OWN-SOURCE STATE-LOCAL REVENUES
ARIZONA	54.3%	19.9%	12.4%	0.0%	12.4%	9.6%	45.7%	18.9%	4.2%	1.7%	20.9%	100.0%
Neighboring States												
California	57.9%	14.7%	25.0%	0.0%	8.3%	9.9%	42.1%	16.1%	3.7%	3.6%	18.7%	100.0%
Colorado	45.2%	8.8%	14.2%	0.1%	8.3%	13.7%	54.8%	23.1%	8.5%	1.9%	21.4%	100.0%
Nevada	56.1%	22.9%	0.0%	0.0%	24.0%	9.2%	43.9%	13.4%	0.2%	7.1%	23.1%	100.0%
New Mexico	72.6%	19.0%	9.3%	6.4%	8.1%	29.7%	27.4%	6.1%	3.2%	1.2%	16.9%	100.0%
Utah	57.7%	16.1%	17.1%	0.6%	7.6%	16.3%	42.3%	19.0%	3.6%	1.8%	17.9%	100.0%
Other Comparison States												
Florida	46.3%	22.0%	2.4%	0.3%	14.8%	6.8%	53.7%	21.0%	0.1%	5.2%	27.3%	100.0%
Illinois	52.4%	13.6%	15.8%	0.0%	12.2%	10.9%	47.6%	25.4%	4.8%	4.3%	13.0%	100.0%
Minnesota	55.4%	11.9%	22.2%	0.1%	10.8%	10.5%	44.6%	19.6%	0.1%	0.8%	24.0%	100.0%
New York	47.4%	8.1%	23.2%	0.0%	7.9%	8.3%	52.6%	22.6%	6.9%	9.7%	13.4%	100.0%
Texas	44.4%	13.5%	0.0%	3.5%	16.0%	11.3%	55.6%	27.1%	3.3%	2.2%	23.0%	100.0%
U.S. AVERAGE	55.5%	13.9%	16.9%	0.7%	11.7%	12.3%	44.5%	20.4%	3.0%	4.3%	16.8%	100.0%

Source: Compilation based on U.S. Bureau of the Census, Government Finances in 1986-87, and State Government Tax Collections in 1987.

44 percent and 58 percent. Arizona is close to the national average with 54 percent of its revenues accruing to the state government and 46 percent being raised by local governments. On average, state-local revenue systems are fairly evenly diversified, relying nearly equally on income, sales, and property taxes. With the exceptions of New Mexico and Texas, for example, all of the comparison states are within seven percentage points of the average property tax reliance of 20 percent.

While Arizona's overall revenue mix does not look extremely different from the national average, the Arizona system does differ from the average in two notable respects: Arizona derives a larger part of its revenues from state and local general sales taxes (24 percent vs. a 17 percent average) and a smaller portion of its revenues from income taxes (12 percent vs. a 17 percent average). Note that the Arizona sales tax proportion is slightly overstated here, since the state severance taxes are included in the State's general sales tax category. It is also interesting to note that while Arizona ranks eighth among the eleven compared states for reliance on the property tax, the Arizona proportion is only 1.5 percent below the national average.

Tax Capacity and Tax Effort

A state's tax mix is a flawed indicator of tax burden resulting from particular revenue sources because it fails to take into account states' varying <u>capacities</u> to raise revenues from particular sources. Tax capacity depends on the underlying economic bases in a jurisdiction, such as mineral wealth, consumption of particular goods or services, income levels, and property values. For example, two states that raise the same amount of revenue through the property tax but have differing aggregate property tax values do not place the same burden on that tax base.

The Advisory Commission on Intergovernmental Relations (ACIR) has developed a methodology that measures each state's tax capacity on an aggregate and tax-by-tax basis. The Representative Tax System (RTS) approach calculates tax capacity in each state by applying national average tax rates to a uniformly defined set of commonly used state and local tax bases. The resulting tax yields, or capacity, in each state thus reflect differences in the underlying tax bases and do not depend on whether or at what level a state actually taxes a particular base. Once capacity is calculated, the tax burden, or effort, placed on each base is computed by dividing actual collections in the state by its hypothetical capacity.

<u>Tax Capacity</u> RTS tax capacity and tax effort data for Arizona and comparison states are presented in Table 8 and Chart 1. The data show that between 1975 and 1986, Arizona's total tax capacity increased from around 92 percent of average to just about average (99 percent of average). In 1986, Arizona ranked 20th out of 50 states and the District of Columbia in total tax capacity. Except for Utah, most of the comparison states have shown relatively high

TABLE 8
RTS TAX CAPACITY AND TAX EFFORT INDICES, 1975–1986
ARIZONA AND COMPARISON STATES

	1975		1980		1982		1984		1986p	
	Tax Capacity	Tax Effort	Tax Capacity	Tax Effort	Tax Capacity	Tax Effort	Tax Capacity	Tax Effort	Tax Capacity(Rank)	Tax Effort (Rank)
ARIZONA	92	108	89	117	96	92	99	95	99 (20)	99 (21)
Neighboring States										
California	110	119	117	102	116	99	119	93	118 (10)	95 (27)
Colorado	106	90	113	90	121	81	121	82	117 (11)	83 (45)
Nevada	145	70	154	60	151	63	146	65	147 (3)	65 (50)
New Mexico	97	85	107	83	115	83	103	85	91 (32)	88 (40)
Utah	86	89	86	101	86	97	81	106	80 (43)	107 (10)
Other Comparison States										
Florida	102	74	100	74	104	72	105	74	105 (15)	77 (49)
Illinois	112	99	108	103	99	107	97	110	96 (24)	106 (11)
Minnesota	97	118	102	111	99	111	101	124	102 (17)	108 (9)
New York	98	160	90	167	92	170	98	158	107 (14)	152 (2)
Texas	111	68	124	65	130	66	117	69	104 (16)	79 (48)
U.S. AVERAGE	100	100	100	100	100	100	100	100	100	100

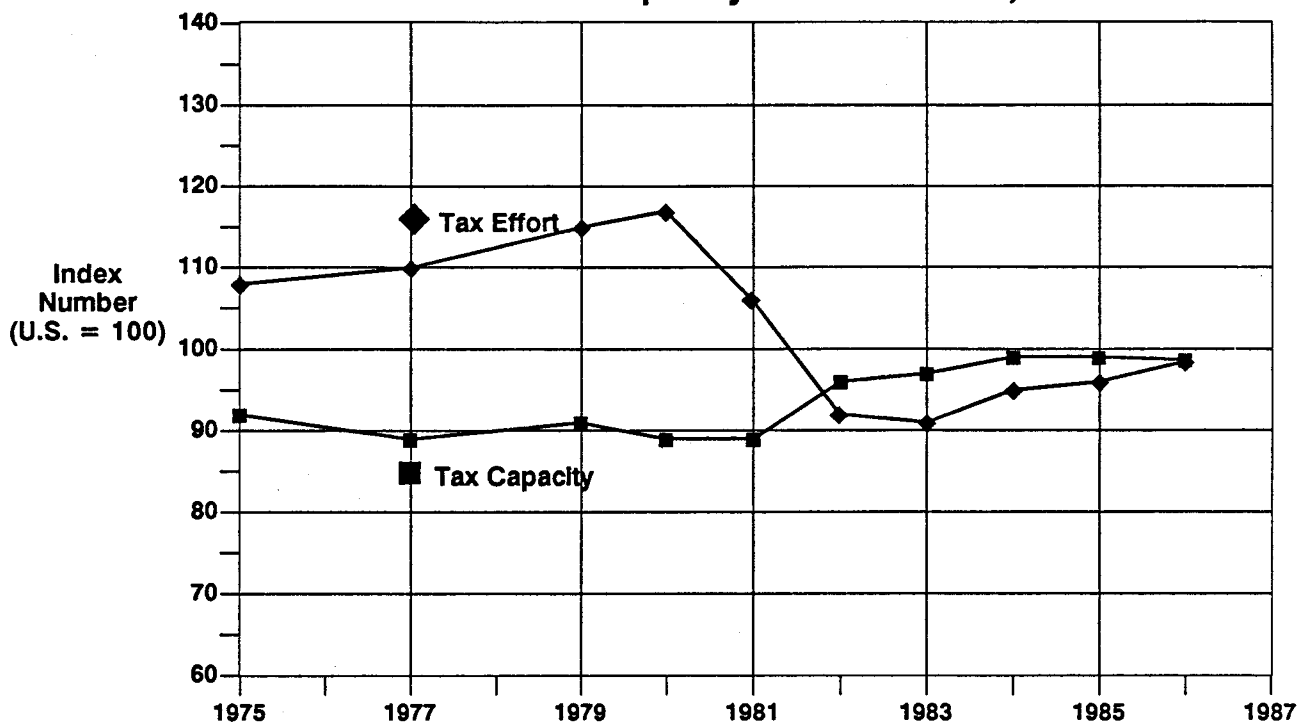
Source: Compilation based on Advisory Commission on Intergovernmental Relations, Measuring State Fiscal Capacity, 1987 Edition, and preliminary estimates from the forthcoming ACIR report, 1986 Fiscal Capacity of the States.

CHART 1

Arizona

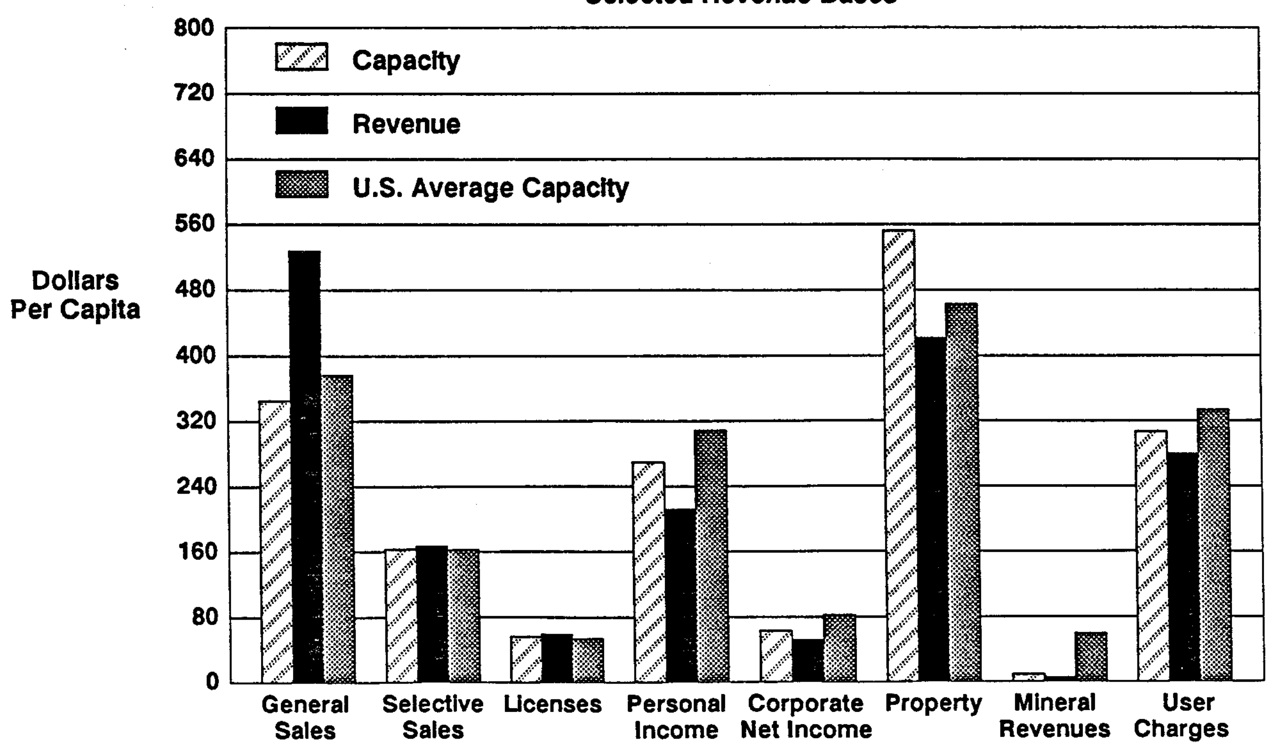
1986 RTS Tax Capacity = 99 **1986 RTS Tax Effort = 99**

Total RTS Tax Capacity and Tax Effort, 1975-86



1986 Capacity and Revenue

Selected Revenue Bases



capacity over this period: Nevada, largely because of its tourism and gaming industries, ranks third in the nation in capacity. California and Colorado also show relatively strong and consistent tax capacities, and New Mexico had above-average capacity for three of the five years shown.

Note that tax capacity in both New Mexico and Texas increased through 1982, then decreased. This pattern reflects the effect of fluctuating energy prices during this period, which strongly affected the fiscal environments of these states. Other regional economic trends are also reflected in these numbers: the decline in the older industrial states (Illinois and New York), particularly during the recession in the early 1980's; the subsequent recovery of the Northeast (New York); and the decline in the economic strength of the farm states (Utah). These results illustrate the sensitivity of the RTS tax capacity measure to the varied and changing economic bases of each state.

The bar graph on Chart 1 shows Arizona's tax capacity relative to the U.S. average for different types of tax bases in 1986. Arizona's capacity was significantly above average for property taxes, and below or near average for all other tax bases.

<u>Tax Effort</u> As shown in Table 8 and Chart 1, Arizona's overall tax effort (collections relative to capacity) dropped sharply between 1980 and 1982 (from 117 percent of average to 92 percent). As of 1986, Arizona's tax effort was just about average (99 percent of average), and ranked 21st among all the states. This indicates that given its underlying economic bases, the state was placing an

overall burden on those bases approximately equal to the national average burden.

Arizona, however, has a higher tax effort than most of its neighboring states. Five of the comparison states--Nevada, Colorado, New Mexico, Florida, and Texas--are among the 12 lowest tax burden states in the nation. The effort indices for these states range from 35 percent below average for Nevada to 12 percent below for New Mexico in 1986. Four of the other comparison states show a significantly different pattern, however: New York, Minnesota, Utah and Illinois all ranked in the top 12 tax burden states in 1986.

Tax Effort by Revenue Source Even though Arizona's overall tax effort is about average, it does not follow that the tax burden placed on each revenue base is also near average. Table 9 presents 1986 tax effort indices for eight selected revenue bases to illustrate that, indeed, this is not the case.

For example, the data show that (relative to capacity) Arizona's tax effort for the general sales tax is 53 percent above average, making it the state with the second highest sales tax burden in the country (after Washington, which had a sales tax effort over twice the national average). Conversely, the tax burdens placed on the individual income and property tax bases are less than 80 percent of average, ranking the state 35th in effort in both cases. The state's effort is also below average to varying degrees for the corporate income tax, mineral revenues, and user charges.

Policy Implications Table 9 is particularly useful for comparing Arizona's tax burdens on specific taxes with those of other states. Because the effort indices for each state are calculated relative to a standardized capacity, the table presents a picture of how intensively each state taxes its potential bases compared to all other states. A state may then be seen to be underutilizing or overworking a particular tax--relative to the national average.

There may be good reasons for a particular state to differ in some respects from the national average. Arizona, for example, may choose to impose a heavy sales tax burden because some of the costs will be borne by non-resident tourists. However, since all types of taxes contain some inherent structural deficiencies and inequities, states have tended to seek diversity and balance in their revenue sources in order to minimize economic problems. Thus, the Committee may wish to consider altering the mix of Arizona's tax burden to bring tax effort for specific tax bases closer to the national average (decreasing the effort on general sales taxes and increasing the effort on income taxes, property taxes, severance taxes, and user charges). The Committee may decide, however, that there are other tax characteristics more important than interstate comparisons, and may conclude that certain "imbalances" are appropriate and beneficial.

TABLE 9
1986 EFFORT INDICES FOR SELECTED REVENUE BASES
ARIZONA AND COMPARISON STATES

	General Sales Tax (Rank)	Selective Sales Taxes (Rank)	License Taxes (Rank)	Individual Income Tax (Rank)	Corporate Income Tax (Rank)	Property Taxes (Rank)	Mineral Rev's (Rank)	User Charges (Rank)
ARIZONA	153 (2)	102 (19)	105 (17)	79 (35)	82 (23)	76 (35)	56 (44)	91 (38)
Neighboring States								
California	113 (13)	78 (45)	59 (46)	119 (20)	160 (5)	72 (38)	63 (43)	102 (28)
Colorado	101 (21)	74 (48)	59 (45)	96 (30)	44 (45)	78 (33)	76 (35)	113 (23)
Nevada	61 (45)	193 (1)	93 (27)	0 n/a	0 n/a	65 (41)	69 (40)	120 (17)
New Mexico	146 (6)	87 (36)	56 (47)	36 (41)	96 (16)	39 (49)	117 (8)	119 (20)
Utah	140 (9)	98 (25)	55 (48)	140 (12)	68 (35)	90 (27)	66 (42)	129 (13)
Other Comparison States								
Florida	100 (22)	142 (6)	62 (42)	0 n/a	77 (27)	86 (29)	303 (1)	106 (25)
Illinois	112 (14)	120 (8)	142 (5)	68 (37)	81 (24)	132 (13)	66 (41)	67 (48)
Minnesota	79 (38)	104 (16)	124 (10)	148 (8)	101 (14)	107 (21)	137 (5)	134 (12)
New York	136 (10)	104 (18)	76 (34)	175 (4)	196 (3)	159 (4)	98 (20)	91 (37)
Texas	87 (29)	97 (26)	197 (2)	0 n/a	0 n/a	114 (18)	81 (32)	100 (30)
U.S. AVERAGE	100	100	100	100	100	100	100	100

Source: Compilation based on preliminary estimates from the forthcoming Advisory Commission on Intergovernmental Relations report, 1986 Fiscal Capacity of the States.

Summary of Expenditure and Revenue Comparisons

Interstate tax comparisons, despite their limitations, provide useful information pertaining to relative tax burdens and expenditure patterns. According to the tax comparison measures examined above, Arizona is an average state in many respects. Despite rapid population growth, Arizona has remained very close to the national average in revenue growth per capita and per unit income, and in overall tax capacity and tax effort. Arizona is somewhat above the national average in expenditures as a percentage of personal income and in revenues as a percentage of personal income. This may be due to the exporting of taxes through the mineral and tourism industries. Arizona also differs from the national average in its mix of taxes and composition of expenditures. As the Committee proceeds with its study of specific taxes and spending programs, the interaction of economic competitiveness and fiscal efficiency, equity, simplicity and accountability will be explored in more depth.

Arizona Joint Select Committee on State Revenues and Expenditures
Fiscal 2000 Study Committee

Models and Methodology Generated by Fiscal 2000

The Final Report of the Fiscal 2000 Study Committee will include twenty to twenty-five research studies, which jointly provide the background for the Committee's recommendations. The purpose of each study is to analyze and evaluate structural features of Arizona's fiscal system, and to determine relationships between population and economic changes and expenditures and revenues. The primary concern of staff is to provide the Committee with the information and analysis needed to make informed recommendations about the structure of the entire fiscal system.

There is concern that the information and analysis provided to the Committee will not be readily adaptable for future use by the Legislature. Although it is not the purpose of this Committee to provide the Legislature with econometric or revenue models, many of the research studies generated for the work of the Committee will involve the use of specific models or methodologies. These tools will be well documented and can be employed on standard statistical or spread sheet computer programs. The Committee's Final Report will be a living document, which, with updated data, can be used by the Legislature to replicate any of the analysis deemed relevant.

What follows is a brief description of some of the methods and data that will be employed for the work of the Committee.

1. The Property Tax

With the cooperation of DOR, staff will obtain property tax data files on assessed valuations and other relevant property tax data for all counties in the state. These data will be loaded, cleaned and assembled by Tracy Clark on the ASU mainframe computer under the supervision of Committee staff. Through September 1989, the Committee staff will use these data to analyze the impact of various potential changes to the structure of the property tax.

At the end of the Committee's process, it will be a relatively simple task to transfer the data to other computers. To keep this a "living" data set, the property valuations need to be updated annually. Models or methods developed by staff to perform policy option analysis on these property data will be documented and made available to all interested government agencies.

2. The Sales Tax (Transactions Privilege Tax)

The methodology employed to evaluate structural changes in the sales tax involves matching sales tax revenue data with consumer expenditure data. We will be collecting the most recent figures and historical figures to evaluate various policy options. The methodology used and data employed will be clearly explained and stored on floppy disks.

As with the property tax, future use of this methodology will require updating the underlying data, but the basic sources are publicly available.

3. The Personal Income Tax (PIT)

The background report prepared by the research consultants for staff use will discuss a variety of structural and policy issues related to the personal income tax. Because the updated DOR income tax model will not be operational before they begin their work on analyzing PIT structural issues, the research consultants will be relying on the output of a proprietary tax simulation model at the National Bureau of Economic Research, Cambridge, Massachusetts. NBER, a privately funded research organization directed by Martin Feldstein, has developed a tax simulation model that encodes the specific instructions from states' personal income tax forms and the data from a sample of federal tax forms by state. DOR has provided staff with Arizona taxpayer information to use in the NBER model. When the Committee begins its policy options deliberations, the Committee will be able to rely on the DOR model to obtain simulation results.

4. Microeconomic Analysis of the Relationship of the Economy to the Fiscal System

A methodology that attempts to determine the statistical correlation between a variety of potential business location factors and the employment growth rate of the economy will be employed for the work of the Committee. Like the sales tax methodology, this econometric methodology can be employed with updated data to investigate similar issues in the future.

The data used in the report for the Committee will be the most recent data available for this type of interstate comparative analysis. These data can be made available on floppy disks, but to determine whether the business location situation has changed in years to come, new data (all available from public sources) would need to be gathered.

health

THE ARIZONA COALITION FOR HUMAN SERVICES

2555 E. First St., Suite 107 • Tucson, AZ 85716 • 323-1303

RECEIVED JAN 4 1988

December 29th, 1988

Arizona Joint Select Committee on State Revenues and Expenditures
Elliot Hibbs, Chairperson
1700 W. Washington, Suite 310
Phoenix, Arizona 85007

Dear Mr. Hibbs and Committee Members:

On behalf of the Arizona Coalition for Human Services, I would like to take this opportunity to respond to your request for information on state revenues and expenditures. In regards to expenditures, I have enclosed a copy of our legislative agenda which clearly presents the areas of need in human services. Our coalition has been actively advocating for human services since its inception in 1983.

While our coalition has been exploring the important issue of revenues, we were not prepared to discuss recommendations at the public hearing which was recently held in Pima County. Notice of the hearing was received two days prior to the scheduled date.

The issue of state revenue is certainly a complex one and we are pleased to know that your committee is working on some solutions to the problem. Our recommendations at this time would be to look at a combination of reallocating priorities at the state level that would free money for other needs, the closure of tax loopholes, and the possibility of increased taxes if that is the only way to fund an adequate human service system.

An example of reallocating priorities might be the criminal justice system. We believe less expensive more effective means of handling people who are not a threat to society could be developed instead of adding expensive prison beds.

We believe there may be tax loopholes in our revenue system which seriously effects the financial base of the state. We would strongly encourage exploring these loopholes with action being taken in this legislative session.

Our coalition is opposed to a food tax, but might support taxing carbonated beverages as a source of additional revenue.

We will be happy to forward any additional input to your committee as our coalition explores this area in more depth. We would also be interested in following your progress and providing any data on human services which might be useful to you.

Sincerely,

Jill Bemis

Jill Bemis
President

cc Sharon Megdal
Jeff Hill

To: The Arizona Joint Select Committee on State Revenues and Expenditures

From: Ruth R. Houghton
2907 East Fairmount
Phoenix, Arizona 85016
Homeowner
Age: 68
Occupation: Executive Director, private non-profit social service agency

Arizona's structure for collecting revenues for the support of public institutions and programs is clearly in need of restructuring. During five of the last six years, the revenues collected under the present system have been insufficient to cover the budget adopted during the preceding legislative session.

The following facts need to be considered:

Property Tax

1. Only 17% of Arizona's total land area is privately owned. (See attached statistical summary.)
   This raises the question of whether the state can afford to give tax exemptions to property taxpayers. It also indicates the importance of having all private land included in school district boundaries.
2. Arizona's property tax rate for homeowners is low. My own annual property tax bill for 1988 is $88 less than my tax bill in Los Angeles County forty years ago - for a single family dwelling valued at one-tenth the value of my present home in Phoenix.

Indigent Health Care

According to published reports, recent growth in Arizona's economy has occurred principally in service industries, which employ workers at low rates of pay and provide no employee benefits.

1. Persons who earn minimum wage ($3.35/hour or $6,968/year @40 hours per week) make too much money to qualify for care under the Arizona Health Care Cost Containment System(AHCCCS). In order to qualify for AHCCCS, a family of 6 must have an annual income of no more than $6,442.(See attached AHCCCS eligibility criteria.)
2. Workers who work for low hourly pay without employee benefits are forced to rely on public health care programs and the public welfare system when they are confronted with

catastrophic illnesses or family emergencies. Emergencies in such families are responsible for much of cost overruns in the AHCCCS program and client increases in Department of Economic Security assistance programs.

<u>Personal Opinions</u>

<u>Sales Tax and Users Fees</u>

1. I believe that the state cannot afford to continue to exempt food from the sales tax.
2. Many other states operate toll roads rather than <u>freeways</u>. It seems reasonable to consider tolls as a possible revenue source.

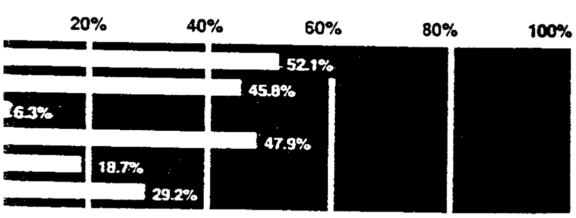
Ruth R. Houghton
December 5, 1988

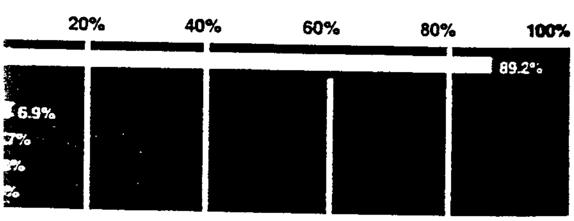
:ORAGE IN ARIZONA RESERVOIRS

ir	Usable Capacity	25-Year Avg. Storage*	Storage As of 4-1-87
	In Thousand Acre Feet		
:sant	157.0	85.3	65.2
:ke	4.7	3.4	4.4
eek	6.1	3.4	5.3
:ock Dam.	2,492.0	999.9	0.0
:s	935.0	368.0	782.3
: Apache,			
:Saguaro	1,710.0	1,248.8	1,621.0
:Horseshoe.	310.0	156.8	293.6
:su	619.0	542.7	553.0
:ve	1,810.0	1,677.0	1,764.5
:t	26,159.0	1,947.3	24,181.0
:el	25,002.0	1,398.8	21,831.0
servoir	31.1	15.4	30.6
:Lake	5.1	2.6	5.1

Soil Conservation Service.

ATER CONSUMPTION AND SUPPLY SOURCES — Normalized 1970 Conditions





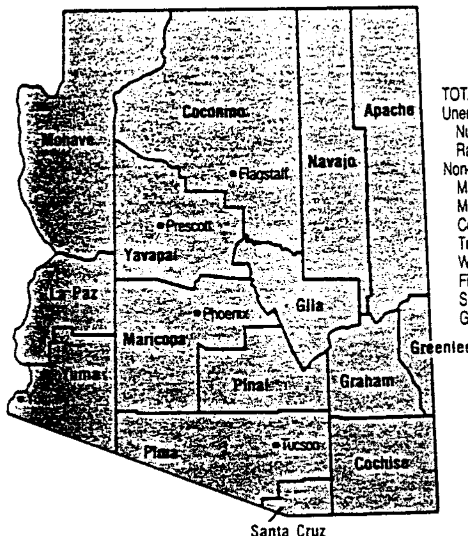
:a State Water Plan — Alternative Futures, February, 1977.

AN ECONOMIC PROFILE OF THE STATE OF ARIZONA AND ITS 15 COUNTIES

AREA

Land — 113,508 square miles; Water — 492 square miles.

Arizona, the nation's sixth largest state is located in the Southwest, and also is one of the Rocky Mountain States. Diverse is the key word in describing Arizona, economically and geographically. The state contains three distinct topographic areas: a high plateau region lies in the northeast corner of the state; a mountainous area runs diagonally through the midsection to the northwestern tip; and the southwestern district is divided between desert valleys and low mountain ranges. These topographic areas all have different climates, which have distinctively influenced development in each region.



EMPLOYMENT

	Annual Avg. 1986	June 1987
TOTAL Employed	1,476,000	1,490,400
Unemployed		
Number	110,000	111,800
Rate (Seasonally Adjusted)	6.9%	6.8%
Non-Farm Wage & Salary	1,341,400	1,351,500
Manufacturing	184,200	184,300
Mining	10,900	11,100
Construction	113,600	105,300
Transp. & Pub. Utilities	66,400	69,800
Wholesale & Retail Trade	325,200	330,900
Fin., Ins. & Real Estate	89,100	91,800
Services	325,900	338,000
Government	226,100	220,300

STATE POPULATION DENSITY

(1987)

30.4 persons per square mile

STATUS OF LAND OWNERSHIP

U.S. Forest Service	15%
U.S. Bureau of Land Management	17
Indian Reservations	28
State of Arizona	13
Individual or Corporate	17
Other Public Lands	10

LEADING CITIES — POPULATION

(1987)

Phoenix (State Capitol)	927,965	Yuma	49,005
Tucson	395,635	Sun City	41,406*
Mesa	259,780	Flagstaff	41,170
Tempe	141,365	Peoria	34,500
Glendale	135,520	Sierra Vista	32,350
Scottsdale	120,045	Prescott	22,400
Chandler	78,600		

*Population as of July 1, 1981

POPULATION

1960 Census	1,302,161
1970 Census	1,775,399
1980 Census	2,718,425
1986 Estimate	3,351,900
1987 Estimate	3,469,000

ECONOMIC INDICATORS

Indicator	1976	1986	% Change
Population	2,270,000	3,351,900	+ 47.7%
Wage and Salary Employment	758,800	1,341,400	+ 76.8
Retail Sales	$8,005,911,000	$18,817,067,000	+135.0
Bank Deposits	$6,746,284,000	$23,844,539,000	+253.4
Vehicle Registrations	1,967,555	2,628,738	+ 33.6
Motor Fuel Consumption (gallons)	1,284,521,000	1,710,437,792	+ 33.2

RACIAL BREAKDOWN — 1980

White	82.4%
Indian	5.6
Black	2.8
Oriental	0.8
Other	8.4
TOTAL	100.0%
Spanish Heritage	18.2%

Arizona Statistical Review

Note: Prior to 1982 Retail Sales figures included food sales.

AHCCCS Brochure

o cuentas médicas que usted adquirió durante el año pasado para ayudarle hacerse elegible. Usted tiene que ser residente de Arizona.

Maximum Annual Income

Persons in Household	Not More Than
1	$3,200
2	4,266
3	4,810
4	5,354
5	5,898
6	6,442

$544 for each additional dependent.

For information on how to be determined Indigent or Medically Needy, call:

COUNTY	CITY	PHONE # AND EXT.
Apache	Springerville	333-5163
Cochise	Bisbee	432-5703, X490
Coconino	Flagstaff	779-6575
Gila	Globe	425-5721, X380 or 381
Graham	Safford	428-6730
Greenlee	Clifton	865-3322
La Paz	Parker	669-6155
Maricopa	Phoenix	244-0210
Mohave	Kingman	753-9141
Navajo	Holbrook	524-2315
Pima	Tucson	746-1073
Pinal	Florence	868-5801, X244
Santa Cruz	Nogales	287-9284
Yavapai	Prescott	445-7450, X288 or 286
	Cottonwood	634-2203
Yuma	Yuma	782-6516

For referral to your local DES or SSA office call:

AZ DEPT.
OF ECONOMIC SECURITY **258-9935**
AFDC Eligibility 1-800-352-8401
(toll free in AZ)

Ingreso Máximo Anual

Personas en Hogar de Casa	No Más Que
1	$3,200
2	4,266
3	4,810
4	5,354
5	5,898
6	6,442

$544 por cada dependiente adicional.

Para información para saber como puede ser determinado Indigente o Necesitado Medicamente, llame:

CONDADO	CIUDAD	# de TELEFONO Y EXT.
Apache	Springerville	333-5163
Cochise	Bisbee	432-5703, X490
Coconino	Flagstaff	779-6575
Gila	Globe	425-5721, X380 o 381
Graham	Safford	428-6730
Greenlee	Clifton	865-3322
La Paz	Parker	669-6155
Maricopa	Phoenix	244-0210
Mohave	Kingman	753-9141
Navajo	Holbrook	524-2315
Pima	Tucson	746-1073
Pinal	Florence	868-5801, X244
Santa Cruz	Nogales	287-9284
Yavapai	Prescott	445-7450, X288 o 286
	Cottonwood	634-2203
Yuma	Yuma	782-6516

Para referencia a su oficina local DES o SSA llame:

DEPT. de AZ DE
SEGURIDAD ECONOMICA **258-9935**
Elegibilidad AFDC 1-800-352-8401
(sin cobro en AZ)

PRELIMINARY COMMENTS OF THE ARIZONA CHAPTER, TAX EXECUTIVES INSTITUTE, TO THE ARIZONA JOINT SELECT COMMITTEE ON REVENUES AND EXPENDITURES

Public Hearing
Phoenix, Arizona
December 5, 1988

The Arizona Chapter of Tax Executives Institute is pleased to present these general comments to the Joint Select Committee on State Revenues and Expenditures.

The Tax Executives Institute (TEI) is the principal association of corporate tax executives in North America. The membership of TEI is composed of more than 4000 members representing more than 2000 of the leading corporations in the United States and Canada. TEI represents a cross-section of the business community and is dedicated to the development and effective implementation of sound tax policy, to the promotion of uniform and equitable enforcement of tax laws, and to the reduction of the costs and burdens of administration and compliance to the benefit of both government and taxpayers alike. As a professional organization, TEI is committed to maintaining a tax system that works - one that is both administrable and can be complied with.

Members of TEI are responsible for managing the tax affairs of their companies and must contend with the provisions of the tax laws relating to the operation of business enterprises. We believe that our diversity and professional training of our members enable us to bring a balanced and practical perspective to the issues to be addressed.

The Arizona Chapter of TEI was chartered in 1976 and holds monthly meetings in the Phoenix area. The Arizona Chapter consists of 28 members representing 23 companies doing business in Arizona.

The purpose of these comments is to suggest a framework within which the Committee might examine the principal revenue sources of the state - sales, property and income tax. These comments are very limited in scope: they do not address taxes or revenue sources other than those mentioned above, do not comment on the individual income tax and do not address any expenditure issues. Moreover, we do not attempt to take a position on any of the points raised herein. We intend to present a more detailed paper with our specific suggestions on what, if any, changes should be made to Arizona's tax laws in the future. Time constraints have limited the scope of the present paper to outlining some of the issues which should be considered in connection with an examination of the sales, property and corporate income tax.

I. TRANSACTION PRIVILEGE (SALES AND USE) TAX

Arizona imposes a 5% transaction privilege tax on the privilege of doing business in the state. The tax is imposed upon the person or entity engaging in business, measured by sales volume. The tax may be, and usually is, passed through to the ultimate consumer and therefore acts in the same manner as a general sales tax. It is supplemented by a compensating use tax and a 2% rental occupancy tax. In addition to the state level tax, some 78 cities and towns in Arizona levy a tax in the nature of a sales tax.

A. Uniform State and City Tax Base

Ideally, a tax should be easily understood, simple to administer and enforce and easy to comply with. We believe the Joint Select Committee should examine the existing system of state/city taxes with this in mind.

Presently, the 78 cities and towns imposing a sales tax may adopt the same base as the state tax but need not do so and, indeed, many do not. Although most cities have now adopted the model city tax code (MTCT), the wide range of options available under the code results in a lack of conformity between cities as well as lack of conformity with the state. For example, food, which is exempt at the state level, may be taxable or exempt depending on the option selected by each city.

There are also many problems in interpreting the various codes. In the best case, terms such as "food" under the MCTC is identical to the state definition. Unfortunately, there are many other definitions that are not consistent such as "manufacturing", "manufacturing equipment" (income producing capital equipment under the MCTC), "expendable items", etc.

The problem for business taxpayers is therefore twofold: numerous separate bases upon which the tax is imposed and differing definitions and interpretations of identical terms. We believe consideration should be given to making a uniform sales tax base mandatory throughout the State.

B. Exemptions

Apart from the question of multiplicity of bases is the question of what a unified base should consist of. Put another way, what business transactions should be exempted from the tax? The state level tax presently has a number of exemptions, principal ones being sales for resale, casual sales, most services, drugs and medical devises, food, and gasoline. In addition, numerous other, more limited exemptions exist. While few would argue over the need for an exemption for sales for resale, the various other exemptions should be examined closely. Important considerations, in this regard are whether the exemption furthers a substantial public interest (e.g., charitable organizations), eases regressivity (e.g., food) or minimizes multiple taxation (e.g., manufacturing equipment).

C. Unification of Audits and Appeals

Under present law, taxpayers are subject to multiple audits on sales tax questions from separate state and local auditors. Often, these audits deal with identical issues and contain the possibility of conflicting results at state and local levels.

Consideration should be given to unifying the audit function as between the state and cities so as to assure that taxpayers are called upon to defend their treatment of a particular item only once, and that the appeals process is binding on both the taxpayer and the government. Successful simplification of the present sales/use tax system would mean that audits could be centralized, most likely at the state level. A simplified system would mean that audits could be conducted more quickly and efficiently, resulting in more audit coverage by the audit agency and less taxpayer time consumed in their individual audit.

Appeals (which should be minimized) would need to be heard only once for the state and cities. Settlements would be expedited and issues resolved quickly and at much less expense in time and money for both the taxpayer and the tax jurisdictions.

Although present law (section 42-1451 A.R.S.) provides that the Department of Revenue may collect and administer any transaction privilege tax imposed by a local authority, and may enter into agreements with such local authorities for coordinated collection and audit functions, the statute is permissive, not mandatory, and is not availed of by many municipalities. In practice, the larger cities and towns in the state have opted not to participate in the program, leaving only small municipalities, which lack the budget and staff to undertake these functions themselves, as participants.

II. PROPERTY TAXES

Generally all tangible property in Arizona is subject to an ad valorem tax imposed by state, county and municipal authorities. Various issues suggest themselves in this area.

A. Property Classifications

Presently, eight separate classifications of property exist, each with separate assessment ratios and some with special valuation rules. In general, the more classifications there are, the less uniform the impact of the tax is. Consideration should be given to minimizing the number of classifications in order to promote fairness and uniformity. Where special rates are desired to encourage retention of land for specific use (such as native desert of other natural, undeveloped condition; agricultural use, etc.) special classes may be justified but statutory definitions should be examined to define such special cases as specifically as possible.

B. Assessment Ratios

There are assessment ratios for each of the present eight classes of property. These vary from 5% (Class 8) to 10% (Class 5) to 15% (Class 6) to 16% (Class 4) to 25% (Class 3) to 30% (Classes 1 and 2) and an annual factored ratio for Class 7.

Consideration should be given to narrowing the disparate range of rates under current law.

C. Special Tax Districts

There are presently 23 Special Taxing Districts listed in 829 pages of A.R.S. - Title 48 - Special Taxing Districts! This tends to create additional record keeping, disbursement of the revenues generated and, a service fee to the county to do so.

The proliferation of special taxing districts creates enormous burdens on businesses to keep track of the physical location of their property. Consideration should be given to reducing the number of special tax districts and re-directing the revenues generated from the fewer resulting authorities. Consideration should also be given to increasing central state assessment, with disbursement back to local authorities, in the case of large industrial and commercial facilities.

D. Primary and Secondary Values

Presently two separate values are calculated, a "primary" value and a "secondary" value. The dual system is confusing to taxpayers and, while it serves an important function in imposing the constitutionally-mandated limitation on growth of local spending and taxing, ways should be explored to simplify the methodology used.

III. Corporate Income Taxes

A. Federal Income Tax Deduction

Arizona along with six other states permit a deduction for Federal income taxes.

The determination of the amount of the federal income tax deduction is often difficult, complex and uncertain. This is true not only because of the mathematics involved (one needs to solve simultaneous equations to figure both a federal tax which allows a state tax deduction and a state tax which allows the federal tax as a deduction) but also because it is not clear how the federal tax imposed on a multi-state non-unitary consolidated group should be allocated to the Arizona jurisdiction of the unitary filing entity. This complexity has spawned considerable litigation. See, e.g., Arizona Department of Revenue v. Arizona Sand & Rock Co., 745 p. 2d 116 (AZ. Sup. Ct., 1987) Motorola v. Department of Revenue, 694 p. 2d 321 (AZ. Ct. App., 1984).

Abolishing the deduction coupled with a reduction of the corporate rate appears to be a simple solution, but this would pose other problems.

First, as a conceptual matter, a tax on corporate (as distinct from individual) income is a business expense as valid as any other. Denying deductions for costs of producing revenue depart from the concept of a net income tax and convert it into a gross receipts tax.

Second, the base upon which an income tax is imposed should measure the ability to pay. Federal income tax is not proportional to a corporation's taxable income. The allowance of credits, exemptions and the alternative minimum tax cause the proportionality to be broken and not to recognize the federal tax as a deduction would therefore distort the tax base as a measure of ability to pay.

An alternative to abolishing the federal tax deduction is to enact new statutory provisions clarifying and providing definitive guidelines to be applied in determining the amount of the federal tax deduction.

B. Minimum Tax

In 1988 a minimum Arizona corporate income of $50.00 was enacted. There are a number of alternatives to this choice.

First, the present concept could be retained with an increase or decrease in the dollar amount. This statement itself points up one problem with a dollar threshold, which is that whatever level is chosen is inherently arbitrary and thus a change in the amount is easily justified whenever revenue needs to be raised.

Second, a franchise-type minimum tax could be employed. Under this concept, which is utilized by a few states, a corporation would pay the larger of a tax on net income or a tax based on the value of the corporate franchise (e.g., stockholders' equity plus funded debt).

Third, a comprehensive alternative tax base, such as is used in the federal system, is possible. The problem here is the sheer complexity of such a system and the severe paperwork burden on both taxpayers and the Department of Revenue. Nor is an attempt to "piggyback" on the federal system a viable alternative since problems of allocation and apportionment would be very severe. Current law is perhaps the lesser of evils in this area.

C. Consolidated Return

Simplicity, clarity and certainty are virtues of a corporate income tax system highly desired by the corporate taxpayer community.

The present unitary system of grouping affiliated corporations for return filing purposes is quite to the contrary,complex, uncertain and in some cases artificial.

A main problem is determining when are subsidiary's business is unitary with another. Present DOR regulations are very restrictive in this regard and often lead to a multiplicity of Arizona returns being filed where only one federal return is needed. Controversies over what is or is not part of a unitary business are a natural consequence of this concept.

Consideration should be given to allowing taxpayers an option to file consolidated returns, utilizing federal definitions.

* * *

The Joint Select Committee has a difficult and important task. We hope that outlining some of the issues which can be addressed in sales, property and corporate income taxes will aid in an examination of one area of the Committee's responsibilities. We look forward to providing more in-depth comments once the Committee has decided on an agenda of areas in which to focus.

Respectfully submitted,

Arizona Chapter
Tax Executives Institute

By:______________________________
Robert E. Ciancola
Chapter Vice President
Tel. (602) 222-6915