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ARIZONA TAX RESEARCH ASSOCIATION

NEWSLETTER VOLUME 62 NUMBER 7 SEPT/OCT 2002

Commentary

Tobacco Taxes and Proposition 303

A shot in the arm or a hazard to fiscal health?

by Kevin McCarthy

On November 5, 2002, Proposition 303 will provide Arizonans the opportunity to increase the tax rate 60 cents on a pack of cigarettes, and varying amounts on other tobacco products.

The increase, which follows a similar voter approved tax increase of 40 cents in 1994, would drive the tax on a pack of cigarettes to $1.18. According to an estimate by the Joint Legislative Budget Committee (JLBC), the added 60 cents will bring in $90.2 million for fiscal year (FY) 2003.

> ***There are times when so-called 'sin taxes' are treated mostly as a fiscal proposition, others when they are portrayed largely in moral terms.***
>
> ***Then there are moments, perhaps including the present, when the two arguments seem to converge. In fact, however, the arguments are not entirely compatible. If government's main goal is to make money off of tobacco and alcohol, it needs to have people drink and smoke more, not less.***
>
> **Alan Ehrenhalt, *Governing Magazine***

JLBC estimates collections will climb to $149 million in FY 2004, the first full year of collections.

However, along with declines in existing tobacco tax collections, receipts on the new 60-cent tax rate are predicted to drop to $146.9 in FY 2005.

In addition to increasing tobacco taxes, an extremely important feature of Prop. 303 is its impact on two *previously approved* voter initiatives.

First, the 1994 initiative to increase the tax rate 40 cents is "reauthorized." As a result of the passage of the "Voter Protection Act" (Prop. 105) in 1998, this reauthorization has the effect of protecting the 1994 tax increase from any future legislative changes.

Second, Prop. 303 provides a partial general fund bailout for the deficit created by Prop. 204, which passed in 2000. Prop. 204, dubbed the "Healthy Arizona Initiative," earmarked all of Arizona's receipts from the tobacco litigation settlement agreement to expand state-funded health care coverage.

Ballot Box Budgeting

Prop. 303 continues what is becoming a familiar practice in Arizona — ballot box budgeting.

Determining state budget priorities at the ballot box, as opposed to the Legislature's appropriation process, has become so accepted that now even the Legislature and Governor participate in the practice.

See *Proposition 303*, page 2

ATRA Outlook Conference, Nov. 15

ATRA's Outlook Conference has long been recognized as providing the most timely look at the fiscal issues facing lawmakers in the upcoming legislation session.

This year's meeting may be the most important in decades as a new governor and a huge freshman class of legislators will confront a billion-plus dollar budget deficit, facing tremendous pressure to do so without further damaging an already floundering economy.

Here are some of the conference activities you won't want to miss:

IS THERE LIGHT AT THE END OF THE TUNNEL?
Legislative budget staff on fiscal outlook

A SOUND BASE OR A WOBBLY STOOL?
A discussion on the performance of Arizona's tax system

THE IMPACT OF ELECTION DAY
Perspective from one of Arizona's leading political columnists

THE VIEW FROM THE NINTH FLOOR
The new governor will give the luncheon keynote address (candidates invited)

The Outlook Conference will be held on November 15 at the Pointe Hilton South Mountain Resort. ATRA's *62nd Annual Membership Meeting* will follow the Outlook Conference.

Call the ATRA office for more details about any of these events. *See you there!*

DON'T FORGET!

ATRA's Annual Golf Tournament
Thursday, November 14, 2002, at the Raven Golf Club at South Mountain.

Proposition 303

Continued from page 1

Historically, special interest groups who were unsuccessful in securing funding in the appropriations process would circumvent the Legislature and attempt to secure funding through an initiative.

However, the last two major tax increases in Arizona, with funding earmarked to specific programs, came from the Legislature and Governor. Prop. 301, approved in 2000, not only increased the state sales tax 0.6% for education purposes, it obligated the state to automatic funding increases for K-12 schools in perpetuity.

The policy implications of ballot box budgeting take on an overwhelming importance in Arizona following the passage of the Voter Protection Act in 1998. That initiative placed strict limits on the Legislature's ability to make changes to voter approved measures. As a result, statutory initiatives, for all practical purposes, rise to the level of constitutional amendments.

Ironically, at the same time the Legislature offers voters the opportunity to earmark more revenue outside the appropriations process, they struggle with a multi-million-dollar deficit that is complicated by the lack of budget flexibility caused by previous initiatives.

Clearly, the most important and fundamental responsibility of the Legislature each year is to establish budgetary priorities within existing revenues and economic conditions.

Ballot box budgeting overrides that responsibility and handcuffs the Legislature's ability to respond to changing demands on the state. Furthermore, by circumventing the annual appropriations process, the earmarked revenues and the programs they fund escape the periodic legislative scrutiny that is so important to maintain accountability for the expenditure of taxpayers dollars.

Shot in the Arm or Fiscal Hazard?

The Legislature cooperated in referring a tobacco tax increase to the ballot because many viewed it as providing much needed relief to a state budget hemorrhaging red ink.

In addition, the proponents of the previous tax increase appeared committed to another initiative effort. The key provision negotiated by the Legislature was the "Prop. 204 Protection Account," which directs 42% of the new revenue to help fund the current deficit in the expanded health care coverage created by Prop. 204. That provision will provide an estimated $62.6 million in general fund relief in FY 2004.

Enticed by the prospect of some short-term general fund relief, the Legislature not only agreed to additional budget handcuffs, they gave little consideration to the long-term effect of the huge tax increase on future tobacco tax collections.

Dramatic increases in tobacco taxes are sold to voters as necessary to discourage people from consuming cigarettes and other tobacco products.

In fact, the impact that the rate increases have on tobacco tax collections proves that there is a negative relationship between **taxable** sales and rate increases. The long-term fiscal impact of the 60-cent increase centers on its impact on smoking as well as **taxable** sales.

Since the first full year of implementation of the 40-cent increase in 1994, annual tobacco collections have declined $13.2 million, a 7.7% decrease. Even without another 60-cent rate increase, JLBC estimates the current tobacco collections to continue to decline in future years. National experts estimate that cigarette consumption will decline by 1.5% a year regardless of future tax changes.

JLBC estimates that Prop.303 will force cigarette consumption down another 5.1% in the first year and then level off again to the current pace of 1.5% reductions annually.

Over and above the current rate of decline in revenue, JLBC estimates that Prop. 303 drives down existing revenues another $19.9 million between FY 2003 and FY 2005.

Taxable vs. Non Taxable Sales

The JLBC fiscal estimate of the impact of Prop. 303 on the price elasticity of demand for cigarettes was based on previous consumer behavior; however, their analysis may have underestimated the impact of such a large increase in price on **taxable** sales.

In 1994, when the tax rate jumped 40 cents, there was considerable concern expressed about driving cigarette sales to the black market. While tobacco collections have declined following that rate increase, a massive drop in taxable sales of cigarettes did not materialize.

The obvious difference between the effect of the 40-cent increase in 1994 versus a 60-cent increase in 2002 is ease of tax avoidance provided by Internet purchases.

While increases in smuggling of contraband cigarettes is a real possibility, the ready access to tax free sales from the comfort and security of the home makes increased Internet transactions a certainty. The associated press has reported that close to 200 vendors now offer cigarettes online.

The savings provided on the Internet are dramatic. According to JLBC, a 60-cent tax increase would drive the average price of a carton of cigarettes to $47. Internet vendors currently offer a carton of cigarettes ranging anywhere from $20 to $35 (shipping included).

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Published 10 times annually by the Arizona Tax Research Association, a nonprofit organization whose purpose is to promote efficiency and economy in Arizona government and reductions at all levels. Permission to reprint is granted to all publications giving appropriate credit to the Arizona Tax Reseach Association.

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County general fund budgets get boost despite struggling economy

Despite a struggling economy, Arizona counties collectively boosted their general fund budgets a generous $204.1 million (13.4%) over last year.

Part of the reason for this year's dramatic increase is a result of the state shifting additional costs to the counties, particularly in the areas of health care and criminal justice. Maricopa and Pima took the brunt of the hit as a result of the state shifting disproportionate share payments to the two counties for a total of nearly $121 million in FY 2003, up from $59 million last fiscal year. Removing this additional cost shift from the total analysis drops the $204.1 million increase to more than $83 million and the percentage increase in total general funds from 13.4% to 5.5%.

Aside from Maricopa County, the largest general fund budget increases occurred in Mohave, with a 17.1% increase, Coconino County at 10.8%, and Yuma, with an increase of 9.9%.

Fourteen out of the 15 counties increased taxes this year and were required to hold truth in taxation (TNT) hearings as a result. The TNT rate is a gage on whether or not government is increasing taxes. For example, if a county adopts the TNT rate, they are maintaining the same level of taxes from the prior year, but still receiving additional taxes from new growth. If the county adopts a primary rate higher than the TNT rate, they are in essence, increasing taxes and are therefore required to notify taxpayers of the tax increase by holding a TNT hearing.

County Summaries

The following are a sample of budget highlights from each county not already identified in the tables on pages 4 and 5.

Despite a 2.7% drop in the overall general fund budget, **Apache County's** fiscal condition is strong as the county continues to hold $8.1 million in reserve.

For the first time this year, Apache County is levying a secondary rate of $0.0513 for the juvenile jail district, which will result in $145,300 in additional revenue. The overall tax rate in Apache County is increasing $0.1235, from $1.4656 in tax year (TY) 2001 to $1.5891 in TY 2002.

The county is benefiting again from "backfill" payments required from electric generation companies as the result of legislation passed in 2000. The "backfill" helps offset the loss in value and ultimately the loss in property tax revenues, under the new valuation methodology applied to electric generation facilities. Total backfill payments received by the county in FY 2003 is $1,400,542 compared to $1,192,678 in FY 2002.

Cochise County experienced a 15% increase in employee health insurance costs this year, costing the general fund nearly $223,000. The county pays 100% of employee coverage but the employee is entirely responsible for the cost of dependent coverage.

The total cost for the $700 one-time pay increase for full time employees will amount to approximately $700,000, with $470,000 coming from the general fund. The county is also adding 8.5 new full time equivalents (FTE's), bringing the total FTE count to 1,057 in FY 2003.

The county plans to build a new service center in Benson, at a cost of approximately $12 million. The center will be funded with $9.25 million in certificates of participation (COP's) over 15 years, with the remainder of the project being funded by the county's half-cent sales tax.

Coconino County's general fund budget jumped 10.8%, reflecting the second largest increase out of the 15 counties, with the general fund budget reaching $38,152,844 in FY 2003.

The 3.3% COLA that the county budgeted for will cost approximately $786,000 to the general fund. Health insurance costs are also increasing from 12%-15%, which will be entirely absorbed by the county.

Coconino is seeking voter approval on November 5th of a 1/8-cent sales tax, which is the maximum allowable sales tax rate that can be levied under the capital projects statute to fund parks & recreation facilities. Under the initiative, the tax will end once $33 million has been raised, which county officials estimate will take approximately 10 years.

The **Gila County** Board of Supervisors decided to keep the primary rate constant this year at $4.4100, which will be somewhat of a relief to taxpayers after last year's 44-cent rate increase. In FY 2003, the county increased its expenditure for water development to $0.2300 of the $4.4100 primary rate, resulting in a levy of $762,740.

Gila ended its contract with Eastern Arizona College for community college services and entered into a new contract with Pima Community College. On November 5th, the county will seek approval to establish a provisional community college district. If passed, the county will no longer need to budget for out-of-county tuition payments, which will provide more than $1 million a year in general fund relief to the county.

The county decided not to give its employees a pay raise. Employee's received a 5% COLA last year.

The Bureau of Land Management paid **Graham County** $1.2 million in FY 2003, up from the budgeted $750,000 in FY 2002, for Payments In Lieu of Taxes (PILT).

The county decided not to give employee raises this year, however, the board awarded each employee with an additional two days of vacation. Last year, employees received a 2.5% COLA.

Greenlee County increased its primary rate 25 cents, driving the levy up 71.3% to $1,039,574, the maximum levy that the county can impose. Part of the reason for the large jump in this year's primary levy is that this is the first year following the county's mandatory reduction in the primary levy as a result of exceeding their expenditure limit in tax year 2000.

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County budgets

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The increase in the primary levy was more than offset by the 27-cent reduction in the county's secondary override rate, which reduced the secondary levy nearly $580,000, down to $1,121,070. This is the second of a two-year override that was passed by voters in 2000. The County intends to go back to the voters for another override election in May 2003.

The **La Paz County** Board of Supervisors established a Public Health Services District to fund the La Paz Regional Hospital, the Quartzite clinic, and the Tri-Valley Medical Center in Salome. The county began levying a 0.112% sales tax on September 1, 2002 that is expected to end on May 31, 2004.

In addition to the Public Health Services District, the county will ask voters in November to approve a property tax to be levied against the hospital district.

Employee healthcare benefit costs have jumped 16%, resulting in a cost of $80,000. The county is also awarding employees with a 3% COLA and market adjustments at a cost $170,000.

Maricopa County adopted the largest general fund budget increase this year with more than a $151 million (18.7%) boost over last year, bringing the total general fund budget to $964,903,437. As discussed earlier, a major portion of Maricopa's increase was unavoidable due to the disproportionate share payment transfer into the general fund. However, without the transfer, the county's general fund still received a healthy increase of over $50 million, 6.2% above last year's adopted general fund.

As a result of the recent passage of HB 2313, the county has placed the question on the November ballot requesting voters to extend the 0.2% jail sales tax, which is not due to expire until 2007, or once $900 million has been received in sales tax revenues. The original ballot measure of 1998, which was slated as a temporary sales tax, will be extended another 20 years if passed by voters.

Mohave County's general fund budget skyrocketed 17.1%, the second highest increase out of the 15 counties. The large increase in this year's budget is partly attributed to the $6 million rise in the unreserved general fund balance as a result of a recent audit, bringing total reserves to $7,242,000.

Mohave County, by far, awarded the highest pay raises this year, with employee salaries increasing anywhere from 6% to 55% and averaging 11% overall. In total, the county will spend approximately $2.6 million for employee raises, in which half of that will come out of the general fund. In addition, the county recently ended a hiring freeze on general fund positions and is planning to fill approximately 100 vacancies over the next fiscal year.

The 5% decrease in **Navajo County's** general fund budget was overshadowed by the board's decision to exceed the levy limit, establish a new special taxing district, and vote to bring a $10 million bond election to voters in November.

For the third year in a row, the county has exceeded their allowable levy limit — this year by $375,537 — to pay for indigent healthcare judgments. The county again exceeded the levy limit despite losing cases with both the Property Tax Oversight Commission and the Tax Court for the previous excess levies.

The Board of Supervisors also established a Public Health Services District, in which the county will levy a secondary property tax rate of $0.0651 in tax year 2002. During ATRA's budget meeting with the board, county officials explained that the new district was necessary in order to divert money from the general fund so that the county could utilize those funds for other purposes.

Finally, Navajo County officials stated their intent to go to the voters in November to request a $10 million capital bond election; however, at the time of the meeting, the board did not have a plan for the projects that would be funded but reiterated that the

See *County budgets* on page 5

County	FY 2002 General Fund	FY 2003 General Fund	Change	% Chg	FY 2002 Beg.balance	FY 2003 Beg. balance	Change	% Chg
Apache	$19,711,349	$19,171,268	-$540,081	-2.74%	$1,600,000	$1,900,000	$300,000	18.75%
Cochise	$43,171,835	$46,718,669	$3,546,834	8.22%	$5,620,894	$7,605,503	$1,984,609	35.31%
Coconino	$34,434,324	$38,152,844	$3,718,520	10.80%	$2,649,233	$7,496,021	$4,846,788	182.95%
Gila	$28,369,998	$28,840,251	$470,253	1.66%	$900,000	$900,000	$0	0.00%
Graham	$12,607,757	$13,485,519	$877,762	6.96%	$791,814	$2,682,916	$1,891,102	238.83%
Greenlee	$5,398,784	$5,830,566	$431,782	8.00%	$400,000	$750,000	$350,000	87.50%
La Paz	$10,062,368	$10,587,927	$525,559	5.22%	$983,575	$1,489,775	$506,200	51.47%
Maricopa	$812,987,134	$964,903,437	$151,916,303	18.69%	$48,034,750	$73,444,803	$25,410,053	52.90%
Mohave	$44,066,929	$51,619,464	$7,552,535	17.14%	$1,242,387	$7,242,000	$5,999,613	482.91%
Navajo	$24,479,010	$23,250,980	-$1,228,030	-5.02%	$370,959	$0	-$370,959	-100.00%
Pima	$301,947,536	$327,246,491	$25,298,955	8.38%	$12,440,040	$20,427,020	$7,986,980	64.20%
Pinal	$66,421,189	$70,730,199	$4,309,010	6.49%	$1,228,791	$553,211	-$675,580	-54.98%
Santa Cruz	$18,547,082	$18,842,136	$295,054	1.59%	$1,810,402	$1,698,066	-$112,336	-6.21%
Yavapai	$59,879,051	$62,618,631	$2,739,580	4.58%	$8,801,458	$5,722,000	-$3,079,458	-34.99%
Yuma	$42,201,295	$46,371,196	$4,169,901	9.88%	$8,909,405	$9,437,257	$527,852	5.92%
TOTALS	**$1,524,285,641**	**$1,728,369,578**	**$204,083,937**	**13.39%**	**$95,783,708**	**$141,348,572**	**$45,564,864**	**47.57%**

County budgets

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purpose of the bond election was to free up revenues from the general fund.

A recent audit of **Pima County's** general fund ending balance resulted in an additional $7.8 million in reserves for FY 2003. The unexpected increase in the fund balance was the result of many variables, including an unencumbered balance of $2.6 million in the Budget Stabilization Fund and an additional $3.6 million in a variety of general fund revenues.

A policy adopted by the Pima County Board of Supervisors in October 1999 requires that all departmental budgets receive a periodic zero-base budget review to compare existing funding to the services provided by each department. The county conducted its first phase of the project for eight departments and the result is a total hit of $14.4 million, with half of that coming out of the general fund. Only two of the eight departments experienced a drop in their general fund appropriations.

The $846 COLA awarded to employees is effective December 29, 2002, which ranges from 2% to 8% on average, along with a 5% step increase for sheriff's deputies, sergeants and corrections officers. In FY 2001-02, employees received a 7.5% pay raise while sheriff personnel received an average pay raise of 10%.

Kino Hospital continues to struggle financially and the county is bailing the hospital out by transferring over $18 million from the general fund to Kino.

Pinal County officials continue to show a beginning fund balance that is substantially lower than the actual fund balance, understating the general fund and total budgets. For example, the unreserved general fund balance is reported in the FY 2003 budget at $553,211. In reality, the unreserved fund balance is nearly $10 million according to county officials.

In FY 2003, the county budgeted to give employees a 2% COLA, along with market adjustments, resulting in an annualized cost of $1.8 million. The county has also budgeted $100,000 for three new FTE's in FY 2003.

The 10-cent increase in **Santa Cruz County's** primary rate, which will generate a total of $7,637,148 in primary property tax levies, brings the county within $168,540 (2.2%) of their levy limit. The county is also at their expenditure limit of $14,218,940.

Health care benefit costs are increasing just over $300,000 and liability insurance is increasing approximately $110,000. The county awarded employees last year with a 2% COLA but were not able to come up with the funds to budget for pay raises this year.

In the past, **Yavapai County** has dedicated 20% of its county sales tax revenues to the general fund and 80% to the road fund. In FY 2003, the Board increased the sales tax distribution to the general fund to 25%, which dropped the allocation to the road fund to 75%.

The county budgeted for a 2% COLA for its employees and a 2.6% merit increase, which will result in a $1.5 million annualized cost to the general fund. Medical benefit costs are increasing 15% this year and will cost the county nearly $200,000. The county is also adding 11 new FTE's to this year's general fund budget.

Yuma County experienced the fourth largest increase in their adopted general fund budget, climbing nearly 10% to $46,371,196 in FY 2003. The 8.6% increase in the county's primary property tax levy brings the county within 5.4% of the maximum allowable levy limit of $14,620,814.

County officials estimated that employee medical benefit costs increased approximately 31%, amounting to nearly $3.8 million in additional costs to the county.

The county has budgeted for a 3% merit increase effective September 2002 for its employees, which will result in a cost of $615,783 to the general fund. The county is budgeting $1,292,200 for 28 new general fund FTE's, bringing total general fund FTE's to 536.

Jennifer Schuldt

County	FY 2002 Primary levy	FY 2003 Primary levy	Change	FY 2003 Tax Rate	TNT Rate	Rate Increase Over TNT	TNT Hearing	Salary Change
Apache	$1,021,763	$1,001,954	-$19,809	0.3632	0.3813	(0.0181)	No	None
Cochise	$14,807,825	$15,794,952	$987,127	2.9373	2.8690	0.0683	Yes	$700 COLA
Coconino	$3,531,465	$4,354,424	$822,959	0.4153	0.3427	0.0726	Yes	3.3% COLA
Gila	$13,629,638	$14,624,715	$995,077	4.4100	4.2736	0.1364	Yes	None
Graham	$1,645,167	$1,736,915	$91,748	1.7912	1.7820	0.0092	Yes	2 vacation days
Greenlee	$606,740	$1,039,574	$432,834	0.5764	0.3624	0.2140	Yes	5% COLA
La Paz	$2,520,195	$2,711,525	$191,330	2.2500	2.1362	0.1138	Yes	3% COLA + Market
Maricopa	$252,676,223	$277,949,612	$25,273,389	1.2108	1.1661	0.0447	Yes	None
Mohave	$17,357,935	$18,283,834	$925,899	1.7500	1.7158	0.0342	Yes	6%-55%
Navajo	$3,543,301	$3,890,835	$347,534	0.6909	0.6515	0.0394	Yes	None
Pima	$177,599,995	$190,135,349	$12,535,354	4.0720	3.9730	0.0990	Yes	$846 COLA + 5% Step
Pinal *	$32,277,736	$37,573,936	$5,296,200	4.4532	4.1526	0.3006	Yes	2% COLA
Santa Cruz	$7,014,033	$7,637,148	$623,115	3.3487	3.1347	0.2140	Yes	None
Yavapai	$20,580,000	$22,310,000	$1,730,000	1.6072	1.5492	0.0580	Yes	2% COLA +2.6% Merit
Yuma	$12,732,082	$13,826,873	$1,094,791	2.3180	2.2380	0.0800	Yes	3% Merit
TOTALS	**$561,544,098**	**$612,871,646**	**$51,327,548**	**2.1463**	**2.0485**	**0.0977**		

* Does not include the Mary C. O'Brien School tax rate of $0.1431.

Proposition 303

Continued from page 2

It is important to note that Internet purchases, when free of tax from the vendor, are subject to use tax in Arizona. As is the case with most tax-free internet sales, the purchaser is responsible for remitting any applicable use tax owed to the state. However, the failure to develop a legal and administratively effective mechanism for taxing internet transactions has left the self-reported use tax largely ignored.

MORALITY OR MONEY?

As previously noted, these huge tax increases are sold on the basis that cigarettes are an addictive and deadly product and dramatic increases in price will discourage their use.

However, Arizona's strategy of dedicating the most of the increased revenue to mandated, on-going expenditure programs is not only a dangerous budget practice, it smacks of hypocrisy.

If approved, Prop. 303 will bring the combined total revenue from the 1994 40-cent tax increase and the 2000 tobacco settlement monies to $344.7 million in FY 2004. Only 7.7% ($27 million) of that revenue is directed to education programs to eradicate smoking.

Further, the lion's share of the money funds programs unrelated to smoking, such as expanded heath care coverage under the Arizona Health Care Cost Containment System (AHCCCS). Such programs remain on-going obligations of the state despite predictable decreases in tobacco tax revenue.

In a recent article in *Governing Magazine*, Executive Editor Alan Ehrenhalt questioned both the sincerity and the fiscal wisdom of state's increasing their addiction to tobacco taxes:

> *"There are times when so-called 'sin taxes' are treated mostly as a fiscal proposition, others when they are portrayed largely in moral terms. . . Then there are moments, perhaps including the present, when the two arguments seem to converge. In fact, however, the arguments are not entirely compatible. If government's main goal is to make money off of tobacco and alcohol, it needs to have people drink and smoke more, not less."*

Until this state's citizens and political leadership recognize the long-term fiscal hazards associated with ballot-box budgeting and the permanent earmarking of revenue, especially in the context of such contradictory policy objectives as are contained in Prop. 303, Arizona's fiscal health will continue to have a very poor prognosis.