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ARIZONA TAX RESEARCH ASSOCIATION

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FY 2005 State General Fund Climbs $855 M

Two year increase tops $1.3 billion (22.3%)

The Arizona Legislature wrapped up the second regular session of the 46th Legislature with the passage of a new budget for fiscal year (FY) 2005. Despite an on-going structural general fund deficit, the Legislature drove spending up 13.2% for next fiscal year. In fact, the total two-year general fund spending for the 46th Legislature climbed $1.3 billion, or 22.3%.

As reflected in the adjacent pie chart, state general fund spending accounts for only 35% of state expenditures. Total state spending for FY 2005 tops $21 billion.

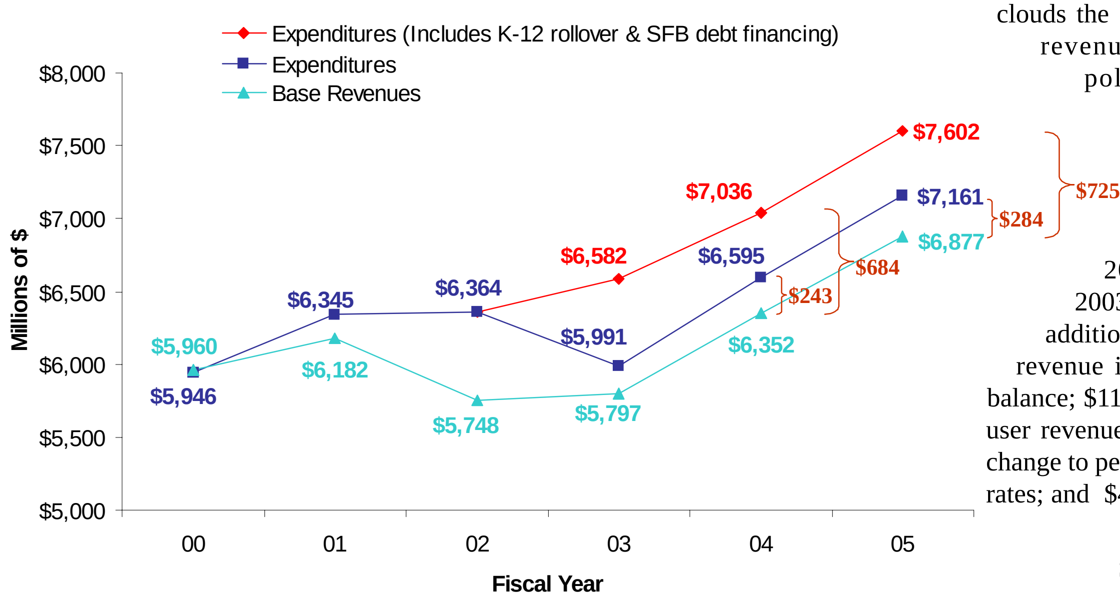
THE DEFICIT

For the last four years, most of the state budget debate has focused on the deficit between on-going revenues and expenditures. The adopted FY 2004 budget, passed in June 2003, carried a structural deficit at that time of $512 million. As a result of revenues exceeding estimates by $372 million for FY 2004, the current year structural deficit fell to $243 million. Disappointingly, that structural deficit actually climbs again for FY 2005 to $284 million.

Arizona's Ongoing Structural Deficit

Comparison of General Fund Revenues & Expenditures

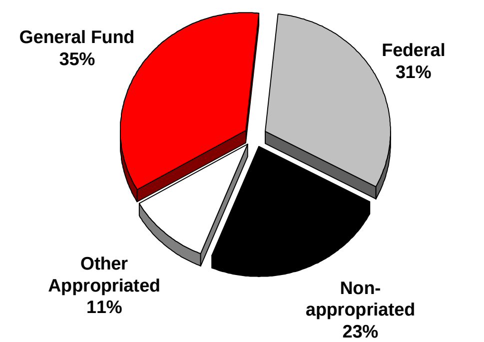
Excludes beginning balance, one-time revenues & expenditures, & Prop 301



Beg. Balance: (in millions)	255	203	13	1	18	243

Source: JLBC

The general fund makes up only 35% of Arizona's $21 billion state budget.



BUDGET GIMMICKRY

While on paper the state's deficit position is improved over this time last year, the continued practice of spending every available dollar, in combination with debt financing on-going expenditures, still clouds the state's fiscal future. Dramatic revenue growth provided state policymakers an unexpected opportunity to improve the state's fiscal picture. With estimated FY 2005 base revenue growth of $897 million (15%) over the FY 2004 budget adopted in June 2003, policymakers still spent an additional $480 million in one-time revenue including: $243 million cash balance; $118 million raid on the highway user revenue fund; $76 million through a change to personal income tax withholding rates; and $44 million in fund sweeps.

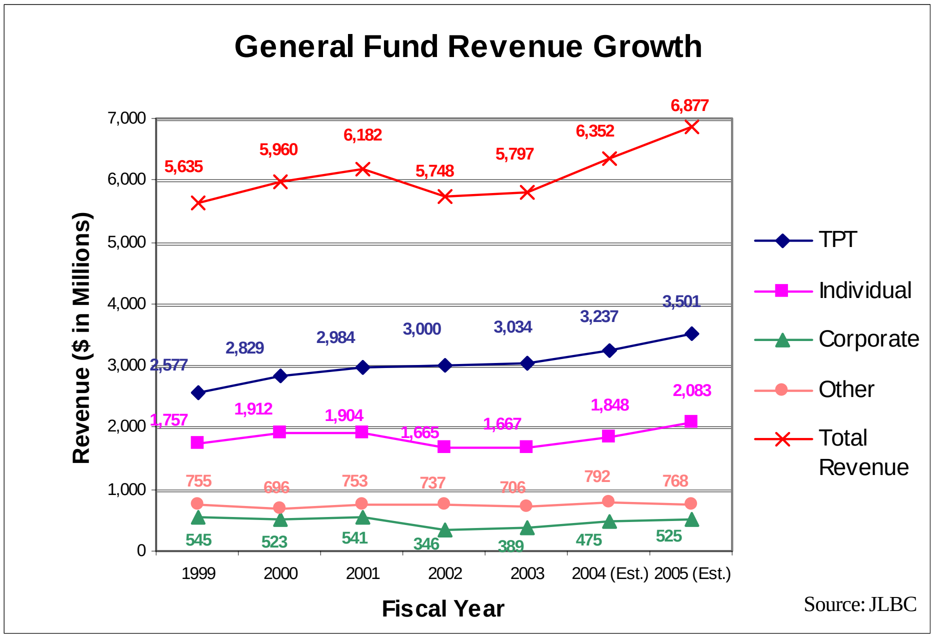
See **STATE BUDGET**, page 2

GENERAL FUND REVENUE UP

Revenue projections are looking up for the state general fund, with the Joint Legislative Budget Committee (JLBC) anticipating fiscal year (FY) 2004 general fund revenues, excluding one-time revenues, to end up with 9.6% ($555.8 million) growth over FY 2003, followed by 8.3% ($524.8 million) growth in FY 2005.

JLBC's revenue estimates for the "Big 3" revenue categories (sales tax, individual income tax, and corporate income tax) are based on an average of four economic forecasts produced by the Finance Advisory Committee panel, the University of Arizona Economic and Business Research (EBR) General Fund baseline model, EBR's conservative forecast model, and JLBC staff projections.

See **GENERAL FUND REVENUE**, page 3



STATE BUDGET *Continued from page 1*

Two years ago the major budget fight was over the issue of debt financing the state's annual costs to build new schools under Students FIRST. This year there was little discussion about the long-term financial impact of financing this obligation. The annual debt service for School Facilities Board bonding is now $88.3 million and climbing. At current debt levels, annual debt service payments will top $200 million by FY 2010.

MISSED OPPORTUNITIES

While budget deficits are never enjoyable for elected officials, ATRA urged state policymakers to view the budget deficit as an opportunity to improve the state's financial management. To that end, ATRA made a number of recommendations to both the House and Senate Appropriations Committees on how spending could be either reduced or better managed. ATRA pointed out numerous funding mechanisms in state laws that are replete with everything from redundancies to ghost funding.

A few ATRA recommendations were implemented including a reduction in rapid decline funding, a continuation of the cap on school desegregation spending, and a cap on the expansion of joint technological education districts.

Another positive note was the Legislature's adoption of the Truth in Taxation rates for both the qualifying tax rate (QTR) and the county education rate. In response to the significant growth in property valuations, those rates will be reduced from $3.9166 to $3.7862 and $0.4717 to $0.4560, respectively, for FY 2005. The Joint Legislative Budget Committee estimates the new rates will offset what would have been a $49 million property tax increase next year.

To be fair, the challenge facing the Legislature to reduce government spending, even that which is clearly unjustified, is a difficult one. Public spending advocates dominate the appropriations process and are largely successful in perpetuating the paradigm that all spending is not only valid but also a high priority.

However, if the Legislature cannot seize the opportunity to clean up a sloppy state budget during tough budget times, it certainly does not bode well for similar efforts in good times.

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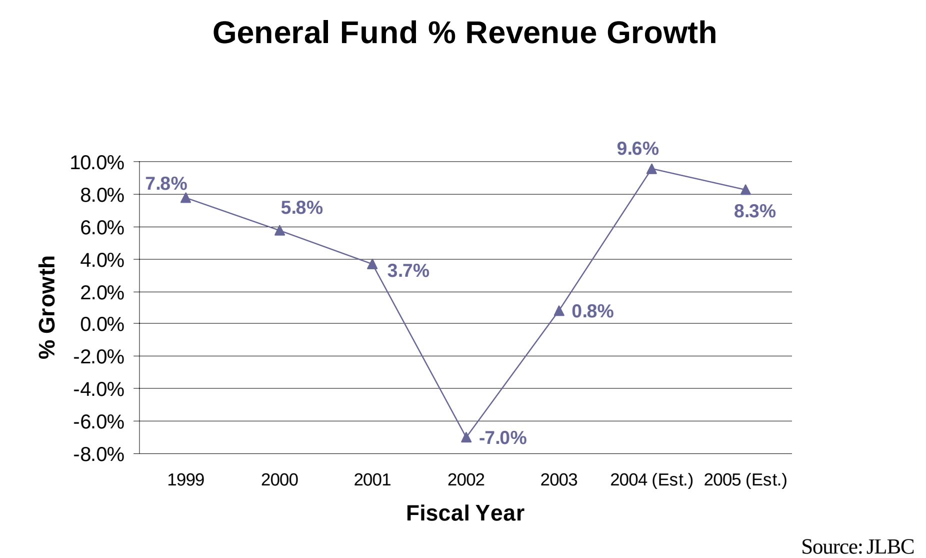
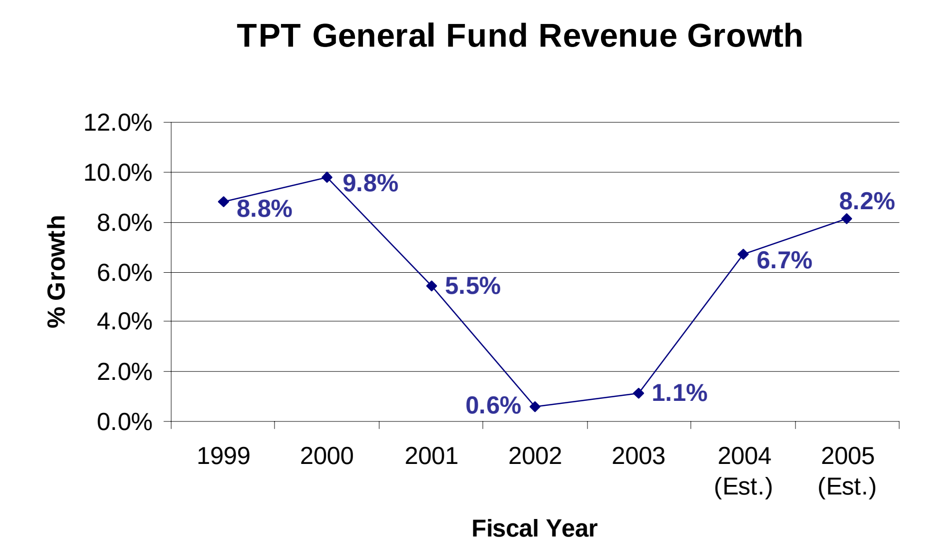


Source: JLBC



Source: JLBC

TPT COLLECTIONS

Fiscal Year	Retail	Contracting	Restaurants/Bars
FY 1998	$1,523,451,796	$428,399,506	$254,772,283
FY 1999	$1,648,221,465	$501,075,437	$273,834,162
FY 2000	$1,820,192,612	$542,357,793	$298,817,599
FY 2001	$1,914,116,656	$562,526,884	$315,041,008
FY 2002	$1,921,642,999	$591,029,823	$321,435,617
FY 2003	$1,970,438,467	$578,186,318	$332,751,378
5-yr $ change	**$446,986,671**	**$149,786,812**	**$77,979,095**
5-yr % change	**29.3%**	**35.0%**	**30.6%**

Source: Department of Revenue

GENERAL FUND REVENUE

Continued from page 2

A five-year analysis of general fund revenues from FY 1999 to the projected revenues for FY 2004 shows that total state general fund revenues increased $717.1 million, or 12.7%. The growth in state general fund revenues gradually began to decline after FY 1999, but still maintained positive growth until FY 2002, when the growth rate dropped dramatically to a negative 7%.

The modest increase in revenues in FY 2003 of 0.8% is followed by a 9.6% jump in FY 2004, dropping slightly to 8.3% in FY 2005. If projections are accurate, state general fund revenues will reach almost $6.4 billion by the end of FY 2004 and up to $6.9 billion in FY 2005.

TPT COLLECTIONS

Distribution of transaction privilege tax collections (TPT) to the state general fund are anticipated to rise $203.5 million (6.7%) in FY 2004 and another $264 million (8.2%) in FY 2005, bringing total TPT collections to $3.2 billion and $3.5 billion, respectively. Sales tax collections make up at least half of total state general fund revenues.

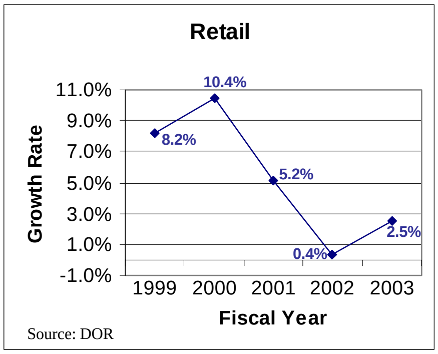
Between FY 1999 and FY 2004, sales tax revenues grew 25.6%, or $660 million, representing an average annual increase of 5.1%. Arizona's TPT system is the only tax that maintained positive growth for the state general fund every year over the last five years.

MAJOR TPT CLASSIFICATIONS

The top three producers in terms of revenue collections under TPT are retail, contracting, and restaurants and bars. Collections from these three categories account for 74% of total TPT collections, with the retail class contributing 50% of total TPT collections. Aside from the 2.2%

See **GENERAL FUND REVENUE**, page 4

GENERAL FUND REVENUE



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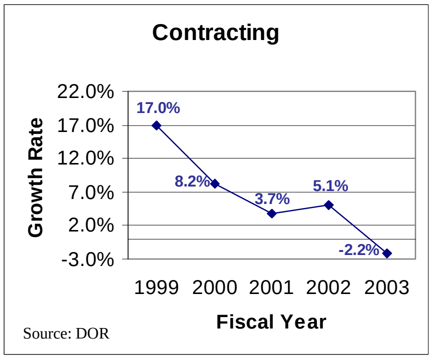

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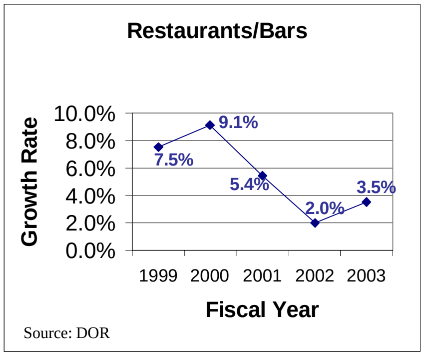


Source: DOR

Continued from page 3

drop in revenues under the contracting class in FY 2003, each of these three categories experienced positive growth every year between FY 1998 and FY 2003. The most growth since FY 1998 occurred in the contracting class with 35% growth, restaurants and bars with 30.6% growth, and the retail class remaining strong with 29.3% growth.

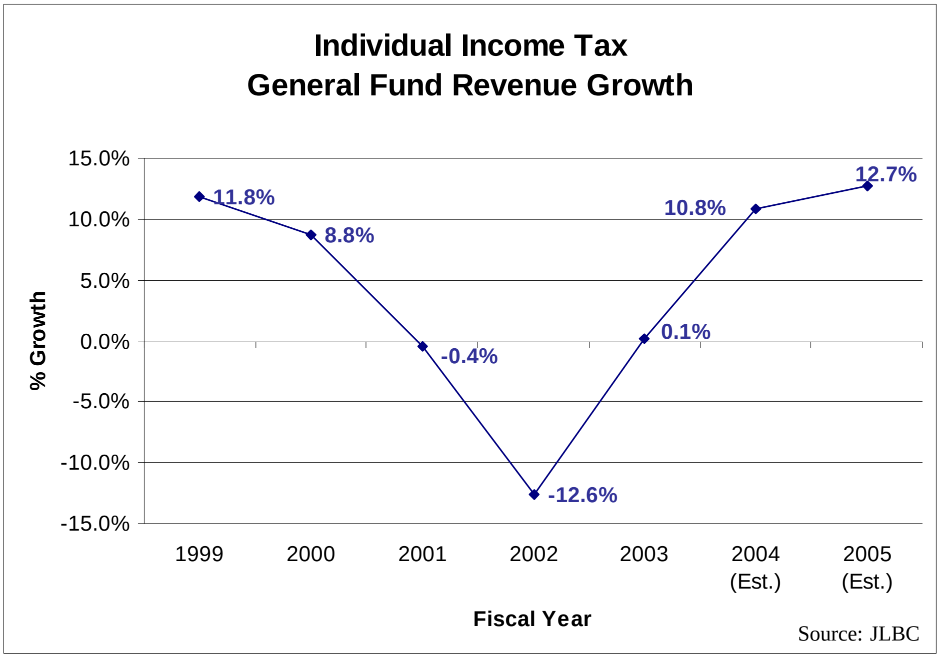
INCOME TAX

Individual Income Tax

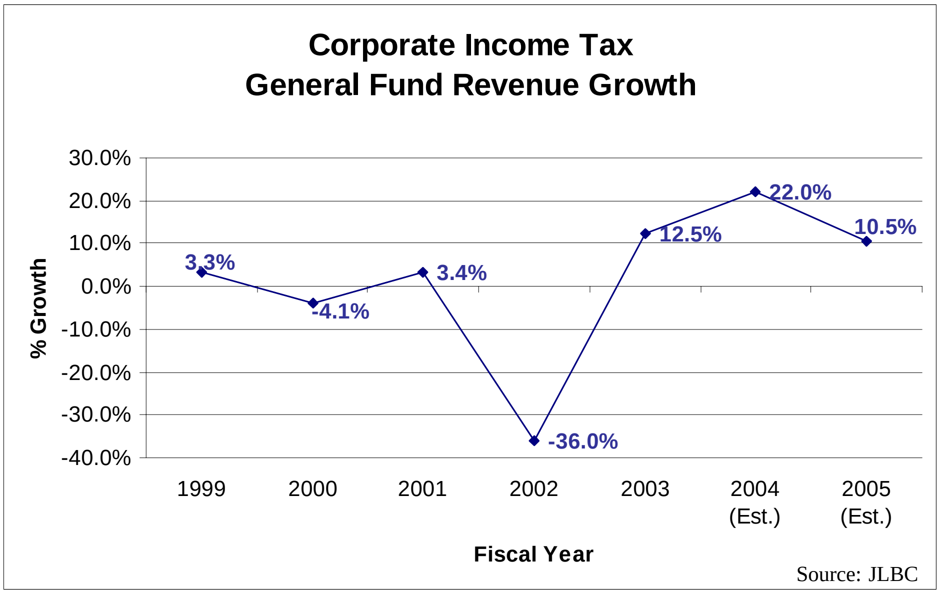
Individual income tax collections make up approximately one-third of total state general fund revenues, which are expected to increase $180.3 million (10.8%) in FY 2004 to $1.8 billion. Continued growth of 12.7%, or $235.2 million, is anticipated for FY 2005, bringing total individual income tax collections for the general fund to just over $2 billion.

Since FY 1999, income taxes have generated an additional 5.1% ($90.2 million) in revenue for the state general fund. However, individual income taxes have not been as reliable a revenue source as TPT has proven to be over the last five years. Individual income taxes started out strong in FY 1999, with 11.8% revenue growth, but gradually dropped to a low of -12.6% in FY 2002, before rebounding in FY 2003.

See **GENERAL FUND REVENUE**, page 5



Source: JLBC



Source: JLBC

GENERAL FUND REVENUE

Continued from page 4

Corporate Income Tax

The corporate income tax is the most volatile of all of the state revenues, with fluctuations ranging from a negative 36% in FY 2002 to a positive 12.5% in FY 2003. Corporate income taxes account for only 7% of state general fund revenues.

JLBC anticipates ending FY 2004 with 22% growth in corporate income tax collections, bringing total collections to $475 million. Collections are expected to grow again in FY 2005, but at a slower rate (10.5%) than in FY 2004, with corporate income tax collections reaching $525 million. Since the corporate income tax is based upon the profitability of corporations, the tax is difficult to estimate and tends to be quite volatile, particularly during difficult economic times.

Jennifer Schuldt

State loses excess utilities suit

The State of Arizona lost an important court case in May that will have a significant impact on local property taxes when school district budgets and property tax levies are adopted this summer.

Maricopa County Superior Court judge Paul Katz, in a decision published on May 12, 2004, ruled in favor of a handful of plaintiff school districts in *Cave Creek Unified et al. vs. State of Arizona.*

The plaintiff districts had argued that the cap placed on school district budgets for excess utilities in 2002 violated the state constitution as amended by Proposition 105. Specifically, Prop. 105 restricted the Legislature's ability to amend statutes that were enacted through initiative or referendum, requiring a three-fifths majority in both the House and Senate to amend any such law.

State law allows school districts to budget for "excess" utilities expenditures that exceed a formulaically determined level based on expenditures in 1985 plus growth. Utilities expenditures, including "telephone communications" that exceed the amount prescribed by the formula, result in an automatic override of the school district's budget limit without a voter approval requirement.

Proposition 301, passed by the voters in November of 2000, contained a provision that eliminates the exemption from the budget limit for excess utilities after FY 2009.

An early indication of the impact this May 12 court decision will have on taxpayers can be seen in the actions of numerous school district governing boards that wasted no time revising their excess utilities budgets for FY 2004 in the few days leading up to the May 15 deadline.

Data from the Arizona Department of Education reveals that latest revisions of excess utilities budgets exceeded adopted budgets by $9.2 million, a 13.6% increase, bringing the statewide total to $76.4 million. With this increased budget capacity, many districts may have negative cash balances resulting in higher tax rates this summer to cover the shortfall.

It remains to be seen what school districts will do with their excess utilities budgets for FY 2005.

Michael Hunter

Tax for Santa Cruz college fails at ballot

Voters in Santa Cruz County rejected a proposal on the May 18 ballot to levy a property tax for the Santa Cruz Provisional Community College District.

Of the 18,327 registered voters in the county, 2,042 (11%) cast votes on the ballot question with 37% voting in favor of the tax and 63% voting against it.

This was the third time a property tax levy was rejected by the county electorate since the district was established by a public vote in September of 2000.

The statutory authority to form provisional community college districts was established in state law in 1999. Provisional districts must contract with an existing college district and do not qualify for certain funds made available to other districts, such as equalization aid.

Currently, Gila County is the only provisional district that is levying a property tax. Unlike Santa Cruz, Gila County put the establishment of a provisional district and levy limit *and* the initial tax levy into one question on the November 2002 ballot.

Gila County also obtained a victory with a recent opinion from the Arizona Attorney General. Gila County had argued that, pursuant to statute, they were no longer required to pay "out of county tuition" to other colleges since they had formed a provisional college district and were levying a tax.

At issue was when, precisely, does Gila County's obligation to reimburse the other colleges end. The argument had been put forward that the obligation does not end until Gila College reimburses the other colleges for students counted in other districts' student counts during the year the provisional district was formed.

The Attorney General, siding with Gila, said the obligation ended with fiscal year 2003, the year the college district was formed.

LEGISLATURE KEEPS FENCE AROUND DESEG/OCR PROPERTY TAXES

A controversial school district property tax was capped again this year after several efforts led by House Ways & Means Chair Steve Huffman to reform the funding mechanism failed during the course of the 2004 legislative session.

Currently, 19 school districts levy property taxes under a state law that since 1985 has allowed unlimited access to property taxes for districts that have either been ordered by federal courts to reform segregationist policies or that have entered into agreements with U.S. Department of Education's Office for Civil Rights (OCR).

In fiscal year (FY) 1991, 10 school districts levied $47.3 million under this statute. By FY 2002, 19 districts were levying $193.8 million, a 309% climb over the 10-year period.

In 2002, the Legislature capped these levies for two years at the FY 2002 levels. This cap also prevented other districts not then levying the tax from doing so.

This year, through the leadership of Senate President Ken Bennett and Representative Steve Huffman, the Legislature's adopted budget for FY 2005 continued a slightly modified cap for one year that allowed for a 2% inflation adjustment and a student count growth factor.

These adjustments to the cap resulted in an estimated $5 million increase overall for a possible statewide total of $197.8 million. This increase is considerably better than what would likely have taken place if the two-year cap had simply been allowed to expire. A fiscal note from the Joint Legislative Budget Committee had estimated the deseg/OCR increases at between $18 and $54 million if no cap were in place for FY 2005.

The student growth factor contributed a relatively small amount to the overall increase since 11 of the 19 districts had declining enrollments and most of the remainder saw only very small increases.

Most importantly, the cap again prevents other school districts not currently levying the tax from doing so. At least a handful of districts that have OCR agreements expressed an interest in levying deseg/OCR property taxes once the cap expires.

As for the taxpayers in the 19 districts, the portions of the school district property tax rates attributable to these deseg/OCR levies will likely decrease somewhat in most of the districts as a result of increases in assessed values.

For example, Tucson Unified's tax rate attributable to their deseg/OCR levy should decrease an estimated 17 cents. Phoenix Union's deseg/OCR rate should drop about 7 cents. Roosevelt's OCR rate may see a decrease of 38 cents.

While the continued cap certainly is better than allowing the previous two-year cap to expire, this 46th Legislature has again ducked the question of substantive reform to the funding mechanism for deseg/OCR compliance. The issue has been placed, unresolved, on the doorstep of the 47th Legislature.

Michael Hunter