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ARIZONA TAX RESEARCH ASSOCIATION

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State Budget Deficit Worsens

Declining revenues add to planned structural deficit

The Joint Legislative Budget Committee's Richard Stavneak presented updated revenue projections to those in attendance at ATRA's annual Outlook conference on November 21, 2008. Stavneak noted that the Fiscal Year (FY) 2009 budget required 1.9% revenue growth **over** the enacted FY 2008 revenue estimate. The bad news for state policymakers is that those revenue estimates, which by all accounts were soft when they were adopted, have turned out to be hundreds of millions too high.

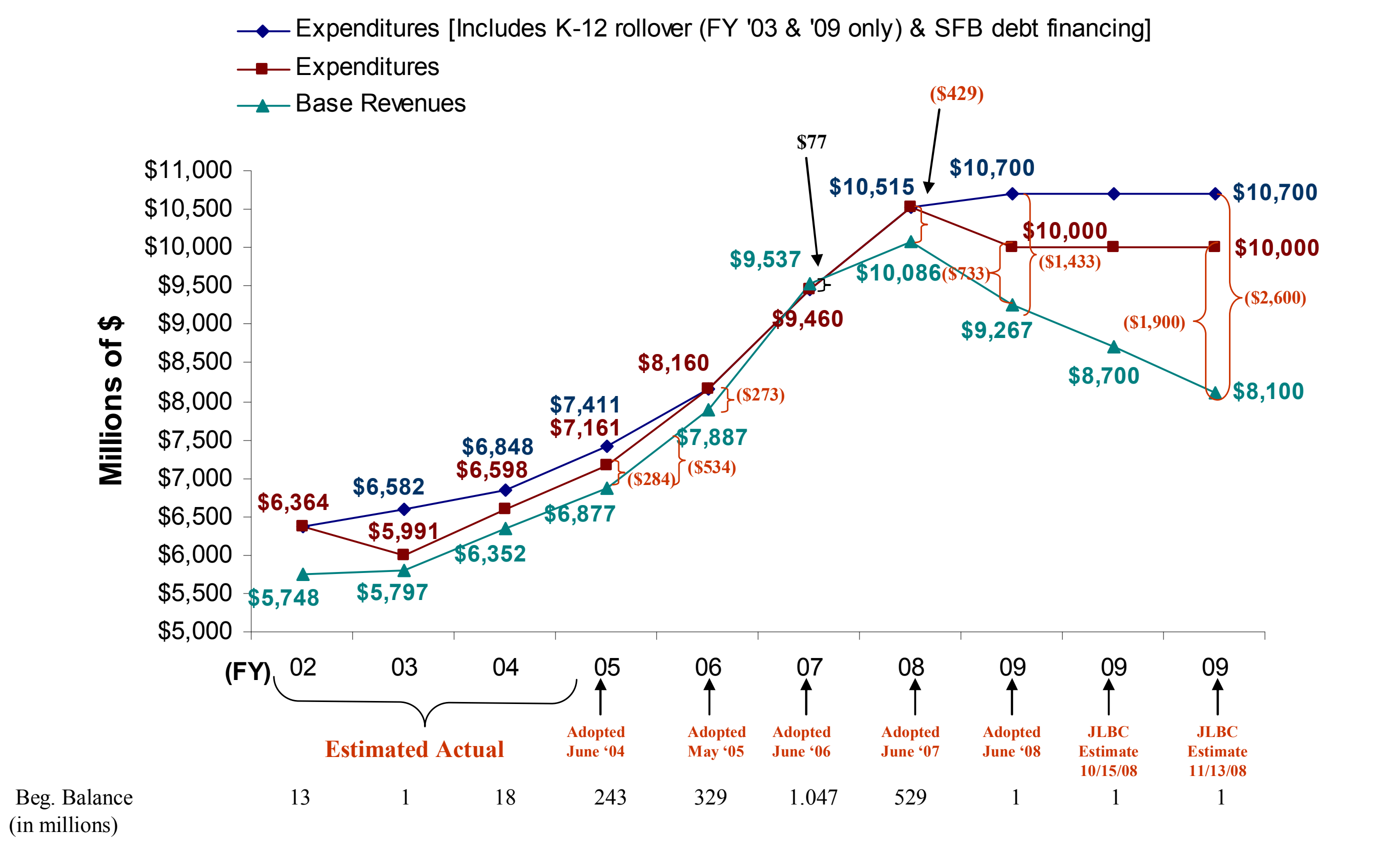
When the FY 2009 budget was adopted in June 2008, few people could predict the depth of the economic problems Arizona would face in the fall of 2008. However, as the chart below reflects, Arizona's budget problem is as much a self inflicted wound as it is a surprise driven by a faltering economy. Arizona's current structural deficit began in June 2007 with the adoption of the FY 2008 budget. That budget contained a structural deficit of $429 million. Regrettably, that planned deficit grew with the adoption of the FY 2009 budget in June 2008. Clearly, even under the best of future circumstances, the state faced major budget problems for FY 2010.

Instead of the best of circumstances, the bottom has fallen out of state revenues. Estimated FY 2009 revenues are almost $2 billion below the budgeted revenues for FY 2008. ATRA pegs the current structural deficit for FY 2009 at $2.6 billion. JLBC estimates the FY 2010 deficit as high as $3 billion.

FY '09 State Budget

Arizona's Structural (Deficit)/Surplus

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



Statewide Average Property Tax Rate Dips to $9.23 – an 81-cent drop

Arizona's 2008 statewide average property tax rate fell from $10.04 to $9.23, an 81-cent drop from 2007. Calculated by the Arizona Department of Revenue, the statewide average tax rate represents the relationship between total property taxes levied and the state's taxable value.

The average primary rate dropped 51 cents, from $6.75 to $6.24, representing a 7.8% decrease. In tax year 2008, primary values, which are limited in annual growth by the Constitution, climbed 15.8%. Primary levies, which are also generally limited in growth by the Constitution and state statute, increased 7%.

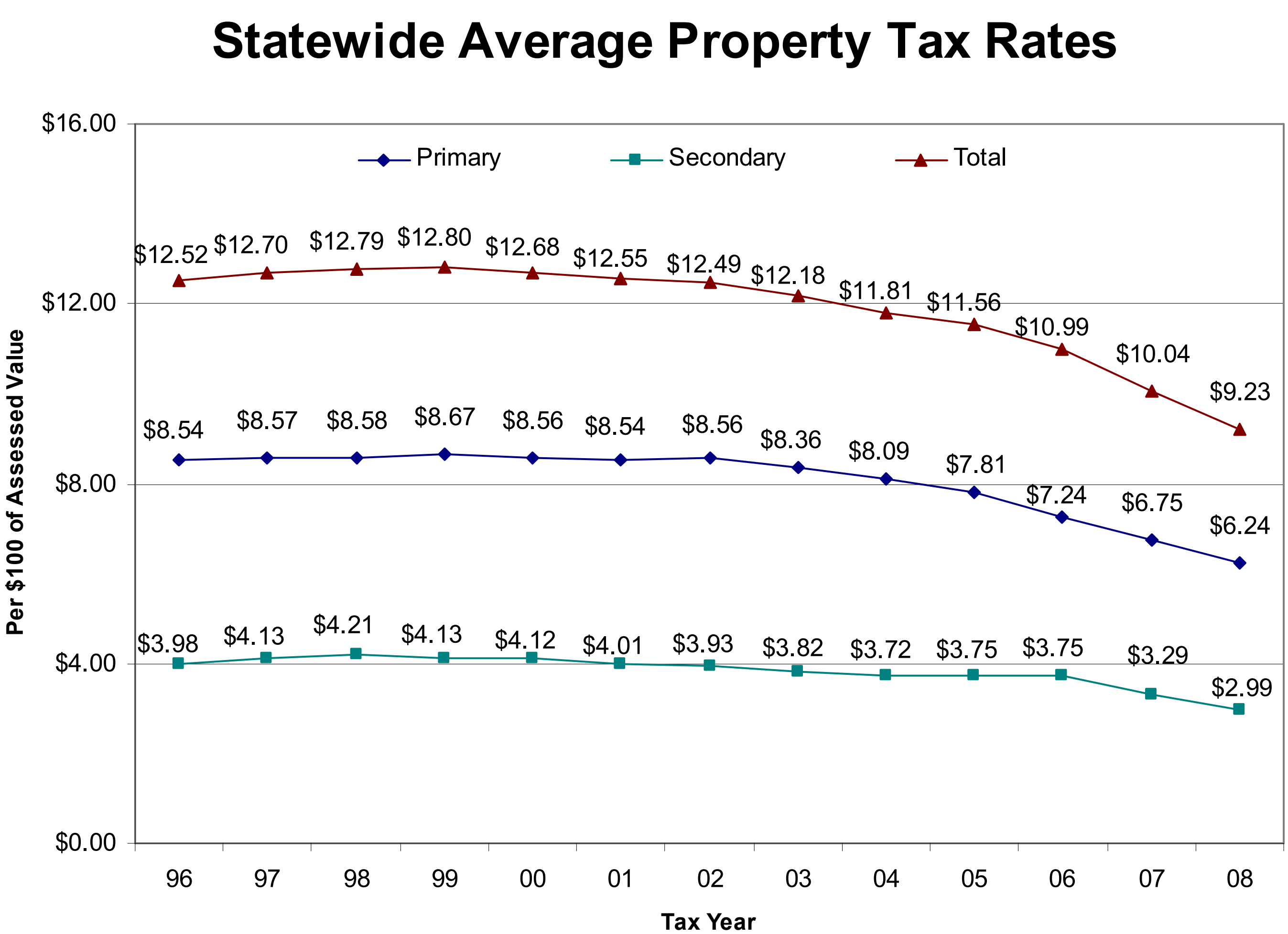
The total average secondary tax rate dropped 30 cents to $2.99. Secondary values, which represent a property's market value, are not limited in the amount they can grow each year. The approximate 20% increase in secondary values resulted in secondary levies climbing 9.1%.

The reduction in the average primary tax rate this year is primarily attributable to the state's continued adherence to the truth in taxation (TNT) law. Another major contributing factor is the passage of Prop. 101 in November 2006 that continues to push the primary tax rate down.

Prop. 101 required a recalculation of the primary levy limits of counties, cities, and community colleges, which eliminated approximately $185 million in excess taxing capacity in tax year 2006. The passage of Prop 101 ensured that each of those local governments' primary levies were in fact limited to 2% plus growth over existing properties.

The state's ongoing compliance to TNT continues to adjust tax rates

See **State Average Rate ,** page 4



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School Districts Budget $590 Million for Budget Limit Exemptions

The state provides school districts the authority to tax property owners at whatever rate is necessary to finance the difference between a district's budgeted expenditures and its budgeted revenues. The state restricts this taxing authority by limiting the amount of expenditures school districts can budget. But the state also exempts certain types of expenditures from these budget limits, thereby allowing qualifying districts to increase property taxes to fund these exempt expenditures. These exempt expenditures increase a districts spending beyond the student-driven budget limits.

For fiscal year (FY) 2009, school districts budgeted approximately $590 million for expenditures that are specifically exempt from the districts' respective budget limits. This was an increase of $33.4 million (6.0%) over the amount budgeted for these exemptions in the previous year.

The majority of this increase resulted from greater levies for excess utilities. The amount budgeted by school districts for the excess utilities budget limit exemption increased by $21 million (22.4%). Interestingly, this significant increase comes just prior to the expiration of the excess utilities exemption. In 2000, voters approved Prop 301 which included an elimination of the excess utilities budget limit exemption. The proposition allowed districts to continue using the exemption for nine additional years while they prepared for the upcoming change. For FY 2000, districts budgeted $57.7 million in excess utilities. Instead of gradually decreasing reliance on this expiring revenue stream, districts have now doubled its use.

As part of the FY 2009 state budget, school districts were given the authority to budget for their actual utility expenses according to a new formula. Many misunderstood that the new formula would replace the majority of the funding for excess utilities. This interpretation of the new formula held that the districts would receive a budget increase equivalent to 90% of the difference between the average of the previous two years' actual utility expenditures and the amount of the previous year's utility expenditures that were funded with the non-excess-utilities portion of the operational budget (see ATRA's July *Newsletter* for a description of what this new formula would cost the state if implemented according to the just described interpretation).

According to this interpretation of the formula, the amount of the budget increase a district would receive in FY 2011 would be greater as a result of higher FY 2009 utility expenditures. This year's 22.4% increase in excess utilities, compared to a 6.1% increase for the previous year, was likely the result of the incentive created by this interpretation of the new formula.

Ironically, the just described interpretation of the new formula is inaccurate, and increases in the FY 2009 utility expenditures will actually have the reverse effect on future budgets. The new formula actually allows budget increases only when the average of the previous two year's utility expenditures is greater than the previous year's total amount budgeted for utilities *including* the amount funded with excess utilities. From FY 2011 to FY 2021 the utility expenditures of FY 2009 will be the baseline year that will be adjusted for growth and then subtracted from the previous two years' utility expenditures in order to determine whether a district qualifies for a budget increase. This means the greater a district's utility expenditures are in FY 2009 the lower any future budget increases will be.

Clearly, it is very likely that the large consumers of excess utilities will seek to amend the new formula during the next legislative session. However, amending the formula so that it operates as described in the first interpretation above would mean creating a new state spending obligation of approximately $81.3 million in a year for which the projected deficit is approaching $3 billion.

See **Budget Limit Exemptions,** page 4

Expenditure	FY 2007-08	FY 2008-09	Change	1-Year Increase
Desegregation	$207,511,248	$211,896,784	$4,385,537	2.1%
Adjacent Ways	$124,647,868	$132,424,913	$7,777,045	6.2%
Excess Utilities	$94,103,171	$115,139,070	$21,035,899	22.4%
General Budget Balance Carry Forward	$92,949,148	$90,026,363	-$2,922,785	-3.1%
Small School Adjustment	$24,310,588	$24,633,161	$322,572	1.3%
Career Ladders Budget Balance Carry Forward	$7,278,936	$9,923,815	$2,644,879	36.3%
Dropout Prevention	$5,649,397	$5,834,540	$185,143	3.3%
Total	$556,450,356	$589,878,646	$33,428,290	6.0%

BUDGET LIMIT EXEMPTIONS, *Continued from page 3*

While increased levies for excess utilities made up the bulk of the increased use of budget limit exemptions, the levies for adjacent ways and desegregation also increased significantly. Adjacent ways levies increased $7.8 million (6.2%) to $132.4 million. Desegregation levies increased $4.4 million (2.1%) to $211.9 million (see ATRA's September *Newsletter* for more details on districts FY 2009 desegregation levies).

Many of these budget-limit exemptions amount to budget overrides that require no voter approval and are not universally available to all school districts. Some of the exemptions are currently unlimited; others have soft caps that were put in place only after years of unlimited growth. As many of the exemptions apply to only a limited number of school districts, these exemptions lead to dramatic differences in per-student expenditures and effectively undermine the equality in school finance that Arizona's budget limits would otherwise accomplish. Nonetheless, the state continues to allow these exemptions, and the qualifying districts continue to increase the extent of their use.

Justin Olson

STATE AVERAGE RATE, *Continued from page 2*

downward in order to offset the rise in property values. The state's TNT law requires an adjustment to the two key property tax rates controlled by the state. The most significant adjustment is the qualifying tax rate (QTR) for K-12 school districts. This rate determines the level of property taxes levied in each district compared to the level of state support to meet the districts' budget. This year, the QTR was reduced from $3.2040 to $2.9244 for unified school districts and from $1.6020 to $1.4622 for elementary and high school districts.

In response to significant concerns surrounding escalated property values over the past few years, the Arizona Legislature reduced the state equalization property tax rate from $0.4358 to zero for tax years 2006 through 2008. Although the reduction in the state rate helped to mitigate hyper property tax growth, Governor Napolitano's veto this year of HB2220, which would have permanently repealed the state equalization rate, allows for its scheduled return next year. The Joint Legislative Budget Committee estimates that the rate will return at approximately 34 cents per $100 of assessed value, resulting in a statewide property tax increase of $250 million.

The average rates vary dramatically across Arizona's counties, from a high of $12.86 in Pima County to a low of $2.74 in Greenlee County. The largest reduction in the countywide average tax rate was Pinal, with the total rate dropping $1.94 to $12.55.

Among taxing jurisdictions, the largest reduction in the average rates was in the K-12 school districts that realized a 56-cent reduction in the combined average tax rate. Of the 56-cent drop, approximately 28 cents was the result of the state's compliance with TNT. The average property tax rate for special districts remained unchanged at 53 cents, despite the significant growth in secondary property values. In many instances, property taxpayers have seen the largest increase in taxes in countywide special districts (flood, library, etc.) and fire districts. Fire districts are limited only by a maximum tax rate of $3.25 and have successfully opposed ATRA's efforts to create levy limitations for special districts.

Jennifer Schuldt