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ARIZONA TAX RESEARCH ASSOCIATION

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ATRA MAKES FY2010 BUDGET RECOMMENDATIONS

Introduction

Arizona's on-going state budget crisis provides a historic challenge for state policymakers. Beginning with the fiscal year (FY) 2008 budget that was passed in June of 2007, state leaders masked a growing structural deficit (see chart below). The adopted FY08 budget intentionally created a structural deficit of over $400 million. As was the case earlier in the decade, that action was grounded in the hope that increased revenues would cover the deficit in future years. Instead, as the economy slowed, state tax revenues actually declined. As the deficit deepened in 2008, the state reacted by adopting a FY09 budget that actually increased spending. The budget adopted in June of 2008 increased the structural deficit to $1.4 billion.

Through the first six months of FY09, state policymakers watched as revenues continued to fall and the deficit climbed. By the time the 49th Legislature and Governor Brewer took action, the FY09 structural deficit had climbed to $2.9 billion.

The FY09 budget deficit was technically balanced in February with a combination of budget reductions ($590 million or 5.6% of the GF budget), fund transfers of $591 million, and an estimated $500 million in federal assistance monies. Depending on the baseline assumptions carried forward from the FY09 reductions, the FY10 deficit remains at least $2.4 billion. Clearly, the on-going structural deficit is even higher.

Arizona's FY10 general fund deficit is one of the largest in the United States. Certainly, Governor Brewer's recognition of the state's structural deficit and the depth of the state's fiscal crisis is a welcome change. Policymaker's efforts to avoid the tough decisions to balance the FY08 and FY09 budgets made the current situation much worse than it needed to be. While the federal stimulus monies provide some assistance as a short-term bridge for the FY10 budget, the state faces a multi-year structural deficit that calls for major corrections to meet a balanced budget in FY11.

Under any scenario, even one including a $1 billion tax increase, there is no prospect for a balanced budget by FY11 unless there are significant reductions in state expenditures in FY10. To that end, ATRA recommends that the Governor and Legislature make every effort to maximize budget reductions in FY10. The recommendations that follow are intended to provide specificity and avoid the standard suggestions that government should simply "tighten its belt." Having said that, the recommendations are not meant to be exhaustive nor is it ATRA's suggestion that all the recommendations be implemented simultaneously. ATRA acknowledges that more across-the-board reductions may be necessary to balance the FY10 budget.

Finally, ATRA encourages the Legislature to maximize its constitutional authority and responsibility over the appropriations process. Too often in recent years, the Legislature has exaggerated the extent to which Proposition 105 limits its authority to control spending. ATRA, and now JLBC staff, have documented that less than 40% of state general fund spending is voter-protected.

ATRA Recommendations:

In recent years, ATRA has pointed out that budget deficits provide a good opportunity for legislators to simplify, repair, and regain control of the many budgetary formulas that drive the appropriations process. Much of what drives state government expenditures involves formulas. Some formulas are as simple as multiplying an established dollar amount by the number of people served, or eligible to be served, by a particular program. In most cases, however, spending formulas are considerably more arcane and complex. Undoubtedly, formulas can be useful tools in the budget-making process, providing benchmarks to determine annual funding levels.

As with other tools, however, it is unwise to allow these state funding formulas to run on automatic, performing the appropriator's work unchecked. In too many cases, formulas contain hold harmless provisions, merge with other formulas, or become obsolete altogether. This results in spending that lacks accountability or that is replete with redundancies. These same flawed spending formulas are sometimes referred to as "statutory" or "non-discretionary" or are grouped unnecessarily with voter-mandated spending.

The following are several specific recommendations to reform such problematic formulas, primarily in K-12 and higher education that are the result of either flawed policies or simply sloppy budgeting. ATRA encourages the Legislature to apply similar scrutiny to other statutory formulas such as those in corrections, health care, and retirement funding.

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BUDGET RECOMMENDATIONS, *Continued from page 1*

Don't exaggerate your obligation to adjust for inflation: Since its enactment in 2000 by Prop. 301, the Legislature has exaggerated its requirement to increase school funding under ARS§15-901.01. Through FY06, this statute required the Legislature to "increase the base level ***or*** other components of the revenue control limit" [emphasis added] by 2%. Some have argued that (for the purposes of this statute only, apparently), *or* means *and*. Therefore, goes the argument, the Legislature is required to apply the 2% factor to both the base level and other components of the revenue control limit (RCL). Despite serious budgetary problems in years past, the Legislature chose to adjust *both* the base level *and* the transportation support level by 2%. From and after FY07, this statute requires the Legislature to make such inflation adjustments by the GDP price deflator or 2%, whichever is lower. During the 1990s, mandatory inflation adjustments were purposefully removed from statute because of the detrimental impact they can have on the appropriations process in lean years. Simply put, increases in funding to hold government harmless from the impact of inflation should not be automatic. Citizens and taxpayers are not necessarily held harmless from the impact of inflation. If the Legislature wants to enact inflation adjustments, it should make that decision because it desires to do so and it has the revenue to do so — not because a statutory formula requires it. The depth of the budget deficit certainly dictates all inflationary adjustments are suspended for FY10.

Manage the general fund exposure to additional state aid costs: "Additional state aid" is money that the state pays to school districts in recognition of what residential property taxpayers would pay were it not for the homeowner's rebate and the 1% constitutional cap on primary taxes. Despite efforts to contain property tax growth through the state's adherence to the truth-in-taxation laws (TNT), growth in local school district property taxes for desegregation/OCR, excess utilities, career ladder, and transportation will result in increased exposure to the state general fund. In FY09, the state spent nearly $75 million in the homeowner's rebate to subsidize school district levies that are outside the equalization system (see table below). For FY09, the Legislature appropriated a total of $405 million in additional state aid. That number is estimated to climb to $414 million for FY10, despite a $14 million decrease from costs associated with excess utilities.

The state should minimize its exposure to the homeowner rebate and 1% cap costs by capping or phasing out local school district levies that are outside the public school equalization system.

FY2009 Additional State Aid

	Budget Increase	Property Tax Levy	Equalization Aid	Homeowners Rebate	1% Cap	Total State Cost
Desegregation/OCR	$211,896,784	$179,242,786	$0	$32,653,999	$0	$32,653,999
Excess Utilities	$115,139,070	$94,970,854	$0	$20,168,216	$160,679	$20,328,896
Career Ladder	$82,539,379	$33,920,162	$36,679,223	$11,939,994	$0	$48,619,217
Hold Harmless Transportation Formula	$59,869,795	$52,005,041	$0	$7,656,004	$208,750	$7,864,754
Small School Adjustment	$24,633,161	$21,999,457	$0	$2,255,199	$378,504	$2,633,704
Total	**$494,078,189**	**$382,138,299**	**$36,679,223**	**$74,673,412**	**$747,934**	**$112,100,569**

Phase out career ladder: Despite the fact that Prop. 301 helped set a policy direction toward performance pay for all school districts in the state, 28 school districts still have the legal authority to participate in a "career ladder" program. The number of participating districts was capped as of FY94 because of concerns raised about the cost and effectiveness of the program. Because it is available to only 28 districts, career ladder contributes greatly to inequities in Arizona's school district spending and taxation.

For FY10, the state general fund exposure for career ladders is estimated at $42 million. Local property taxes will add another $45 million in career ladder funding.

In addition, property tax levies on residential property for career ladder also exposes the general fund to additional state aid costs of roughly $10 million.

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Move from "prior-year plus growth" to current year funding: School district funding is based on the prior-year's 100th day student-count plus current-year growth. The system therefore holds districts harmless for reductions in enrollment from the prior year, even though state taxpayers may be funding those very same students at another district or charter school. The state moved from prior year funding to our current method of funding both prior and current year counts in 1999 in an effort to help fast growing school districts. In a state with open enrollment and charter schools, the policy arguments for funding current year counts outweigh funding on a prior year basis. The duplicative and ghost funding associated with the dual funding scheme is unacceptable. ATRA staff estimates that the redundant funding in this area cost the state roughly $29 million in FY09.

Ensure districts properly report students: The Legislature needs to continue to develop better oversight over student counts to ensure that the growing demands on taxpayers to fund student growth are legitimate. Press reports regarding fraudulent accounting of students in some school districts suggest there is a need for better auditing at the state level.

Districts are allowed to adjust their student counts in certain circumstances, such as widespread illness or adverse weather conditions. Surprisingly, this list also allows an adjustment for "concerted refusal by students to attend classes for three consecutive days or more." Again, sometimes these students are actually attending another district or charter school.

As a result of an on-going disagreement between school districts and the Department of Education (ADE), the Legislature has passed session law in recent years to make clear that the Department has the authority to audit district student counts. There should be no dispute regarding the importance of ADE auditing student counts and this authority needs to be made clear in permanent statute.

Eliminate rapid decline funding: School districts that experience declining enrollment for more than one year (they are held harmless automatically for the first year) may be eligible for additional "rapid decline" funding. ATRA supported the Legislature's successful effort to fund rapid decline at 50% between FY05 and FY08. For FY09, 100% of rapid decline was suspended. ATRA recommends this statutory formula now be permanently repealed.

Phase-out the Teacher Experience Index (TEI): The TEI is a weight in the school funding formula that provides more money for school districts whose teachers have more experience than the statewide average. JLBC estimates the cost of this program at $58 million for FY10 and $16.4 million (28%) of the TEI monies are directed to just one Arizona school district. ATRA concurs with the recommendation in the FY10 Appropriations Chairmen options to phase out the TEI over the next eight years. The estimated FY10 savings are $7.3 million.

Eliminate "Early Kindergarten:" Current law requires children to turn five prior to September 1 to be admitted into kindergarten. However, school governing boards are allowed to admit a child who turns five by January 1 if it is determined to be in the best interest of the child. ATRA research of ADE data shows that many of those kindergarteners who are four years old on September 1 are simply repeating kindergarten the next year. In fact, 44% of the four-year-olds that repeat kindergarten are in one large school district.

Then Arizona Attorney General Janet Napolitano opined in 2000 that students in a kindergarten program that is not designed to move them to first grade should not be counted for state aid purposes. Clearly, it was never the state's intention to fund an "early kindergarten" program. Amending state law to require kindergarten students to turn five prior to September 1 would end this practice and save the state $26 million in FY10.

Eliminate Early Graduation Scholarship Program: This was a new program established in 2007 that Arizona can no longer afford. This program requires ADE to continue to provide funding to school districts for students who graduate early. ADE directs a portion of the extra funding to the scholarship program. The amounts transferred to the program are $2,200 for students who graduate at least one-year early and $1,700 for students graduating one semester early. JLBC estimates that the increased state aid costs for funding these students who are no longer in Arizona high schools is $4.7 million in FY10.

Reform Joint Technological Education District (JTED) funding: State law allows two or more school districts to create a new taxing district for the delivery of technological training to high school students. JTED's were first created on the basis that expensive vocational and technological training was best delivered when multiple districts combined resources and avoided the redundancies associated with each district providing these expensive programs on their own. Theoretically, the state would be held harmless as the funding would follow the students who left their high school to attend a JTED. Since their creation in 1990, JTED's have been embroiled in controversy. A 2004 Auditor General report outlined a number of problems and inefficiencies associated with JTED's including the redundant funding of students. The state's budget crisis necessitates a complete review of how JTED's are financed. The state should give serious consideration to moving the funding for these special districts to the taxpayers that created them. Such a move should be accompanied by reforms that ensure JTED property taxpayers are protected from the duplicative funding currently paid by the state.

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Reduce formulaic funding for online courses or "virtual" schools: Noteable expansion and growth has occurred in the online delivery of courses in higher education and K-12. Funding adjustments should be made for schools that employ delivery methods that do not require the level of funding needed in more traditional environments.

According to JLBC, $1.6 million could be saved by funding the Technology Assisted Project Based Instruction (TAPBI) program at 85%.

Eliminate the School Facilities Board (SFB): The state's loss in the *Roosevelt vs. Bishop* case necessitated a change to Arizona's scheme for funding school capital. New school construction funding was the centerpiece of the Students FIRST program that was passed in 1998. ATRA believes the funding for new school construction would be more efficiently accomplished through JCCR as opposed to the SFB.

Eliminate invisible square footage for new construction qualification calculations: School district square footage that is built with local option dollars (class B bonds or overrides) is invisible to the state, while students within the walls of that square footage are not invisible in the "pupil per sq. foot" calculation to determine if a school qualifies for new construction.

Eliminate automatic 5% additional funding for statutorily-defined "rural" districts: Students FIRST statutes require the SFB to add 5% to new construction and building renewal formulas for "rural areas." Rural is defined as a district outside a 35-mile radius from the boundary of a municipality with a population of more than 50,000. The formula generates some interesting results. Globe is rural; Miami is urban. Skull Valley is rural; Kirkland is urban.

Eliminate state aid for out-of-state university students: An estimated 28% of the full time student equivalent (FTSE) in the university system are classified as out-of-state students. In most state university systems across the country, out-of-state students pay higher tuition and are not counted for state aid purposes. In Arizona, out-of-state students pay higher tuition rates but are also treated the same as in-state students for purposes of drawing down state aid.

Eliminate the community college hold harmless formula: Operating state aid for colleges typically increases through student growth but never decreases for declining student counts. For example, say a hypothetical district started with 1,000 FTSE. In the following year, that district's student count declined resulting in 800 FTSE. The funding formula holds the district at the 1,000-FTSE funding level. A district's operating state aid cannot be increased until the FTSE count exceeds the highest recorded FTSE since FY04. While the FY09 budget reduced operating state aid below the FY08 levels, the hold harmless feature of the formula still influenced the size of the reductions across the districts. Any further reductions to community college operating aid for FY10 should include an elimination of the hold harmless provision.

Reduce or eliminate redundant funding through dual and concurrent enrollment: Community colleges, high schools, and JTED's often enter into agreements that can result in two or more entities counting the same students for the same seat time for funding purposes. Funding should go only to the entity providing the services or should be distributed proportionately. According to JLBC, eliminating the redundant funding for dual enrollment will save the state $4.4 million in FY10.

Eliminate the community college "equalization assistance" formula: Four of Arizona's eight "rural" community college districts qualify for equalization assistance from the state general fund. The key driver in this formula is the average net assessed value (NAV) for the eight districts. The further a district is below the average, the more money it gets from the state. The formula for FY08 resulted in a $23.5 million cost to the general fund. Unbelievably, the FY09 appropriation for equalization aid increased $4.4 million while operating aid for all districts decreased. In fact, this formula, which distributes monies to colleges without regard to changes in student growth, has climbed 151% in the last five years. The equalization assistance formula was designed to provide money to Eastern Arizona College when the system was established. The formula should be eliminated and state support for Eastern should be through direct appropriation.

Eliminate the out-of-county reimbursement subsidy: Counties that are not part of a community college district are charged an "out-of-county" reimbursement for students from their county that attend one of Arizona's community colleges. This charge is in recognition of the fact that taxpayers in those counties (Apache, Greenlee, and Santa Cruz) are not funding a district of their own. This reimbursement is based on the college's per-student level of expenditures minus the college's per-student amount of state aid. For years, the affected counties have argued the charges are excessive and inequitable. Instead of correcting this inequity, the Legislature subsidized these counties with state monies to partially offset the payments. The Legislature should eliminate the subsidy and should correct the reimbursement formula to only include the per-student amount of property tax dollars raised by the college district.

Eliminate state aid for out-of-state community college students: As is the case with the universities, Arizona taxpayers subsidize the education of out-of-state students in the community college system as they are included in the district FTSE counts for state aid purposes.

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Eliminate state aid to community colleges for recreational classes: The state's taxpayers have an interest in providing funding to community colleges for academic and technological training. However, taxpayers should question what the state is paying for when credit is awarded for recreational courses and as such receive state funding. Courses like *Single Again, Coping with Stress, Humor and Play*, and *Creative Grandparenting* have appeared in community college catalogs. Other courses that have been offered in Arizona community colleges might lead one to question whether they are truly at a college level: *Approaching Math Positively, Notetaking, Testing Tips,* and *How to Study* have been offered for college credit and therefore generate state funding.

Reform the state's retirement programs: The defined benefit retirement programs for Arizona's public employees are some of the most lucrative in the country. Even before the recent economic downturn, the taxpayer's costs associated with funding these programs increased substantially. In fact, from 2000 to 2008, the taxpayer costs for funding the retirement portion of the Arizona State Retirement System increased 951%. The taxpayer costs to fund the Public Safety Personnel Retirement System (PSPRS) have climbed 354% over the same period. The contribution rate for employers (taxpayers) in PSPRS has increased from 5.29% in FY2000 to 22.00% for FY09. Unbelievably, while the taxpayer costs to fund PSPRS skyrocket, the system continues to fund benefit increases to retirees through "excess earnings." Regrettably, this same situation is the case for both the Correctional Officers Retirement System and the Elected Officials Retirement Program.

Clearly, recent declines in the stock market will drive taxpayer costs for these programs even higher while, at the same time, taxpayers see their private retirements decline dramatically. State leaders should recognize that the current defined benefit structures are unsustainable and the benefits should be decreased for new employees entering the various systems.

Stop adding to the problem: Every year, the Legislature is asked to codify in statute formulas that further erode the Legislature's flexibility to deal with spending demands and priorities. Worse, in order to side-step the difficulty of funding new programs, the costs are often phased in, leaving to future legislatures the real burden of funding them.

Final points: Arizona state policymakers are faced with a record budget deficit. Closing that deficit will require the Legislature and Governor to make some very difficult decisions. ATRA encourages the Legislature and Governor to view the difficult task of reducing spending as an opportunity to also improve the state's financial management. Reductions in spending should be combined with reforms to these flawed formulas and policies in order to better position the state finances in the future.