ATRA SPECIAL REPORT

March 2016

Action without information is dangerous. Information without action is futile.

ATRA Supports Proposition 123

A FAIR RESOLUTION TO A BAD COURT DECISION

ATRA supports the decision of Governor Ducey and legislative leaders to resolve the *Cave Creek* lawsuit with the referral of Proposition 123 to the ballot on May 17, 2016. ATRA believes this measure avoids a Constitutional crisis and resolves the lawsuit in a manner that does the least amount of damage to Arizona taxpayers. This support is in spite of ATRA's strong belief that the court's decision that "or" means "and" was wrong as well as the court's calculation for the reset Base Level amount. This paper will contextualize ATRA's support for the settlement, its impact on taxpayers, the State Land Trust and how policymakers must begin preparing for the post-settlement.

BALLOT BOX BUDGETING STRIKES AGAIN

After a decade in the 1990's of successfully removing a myriad of mandatory funding formulas that handcuff lawmakers in the appropriations process, the inflation demands of Prop 301 in 2000 represented a major setback to that progress. Ballot box budgeting circumvents the legislative process by locking in spending increases irrespective of available revenue or other budget demands, effectively neutering the legislative body of their elected duty. Following the Legislature referring Prop 301 to the ballot, ATRA wrote in June 2000:

> *"Clearly the intent of this provision is to adjust the base level, but the phrase "or other components" of the RCL is curious. What this means, however, is that the legislature could choose not to increase the base level, opting instead to adjust any one of the other components, say, for example the limited English proficiency (LEP) multiplier...The return to mandatory inflation adjustments is one of the more troubling provisions of SB1007."*

Although the "or other components" language seemed to provide flexibility, ATRA warned the inflation demands protected by voter approval would limit legislative authority. The Great Recession provided the crisis and put lawmakers in the inevitable position of having to leverage the "or other components" clause. Indeed, it was a tall order through the recession to simply keep the Base Level at existing levels which required increases for student growth. By contrast, state agencies, universities and other discretionary programs underwent major budget cuts. When the Legislature chose to inflate "other components" and not the Base Level, Cave Creek Unified and a number of other K-12 plaintiffs sued the State of Arizona.

THE CAVE CREEK LAWSUIT

The Superior Court dismissed the original *Cave Creek* lawsuit and asserted that the voters could not direct appropriations of the Legislature.

On appeal, the Arizona Court of Appeals reversed the lower court's ruling and sided in favor of the plaintiffs, arguing the voters intended on mandating the Legislature inflate the Base Level in every year by inflation or 2%, whichever is lower. It was this ruling that famously directed that "or" meant "and" meaning the Legislature must inflate all formulas annually and could not choose to inflate just one of the other components. The court relied on *State v. Estrada* where the court held that "even where statutory language is clear and unambiguous, we will not employ a plain meaning interpretation [that] would lead to . . . a result at odds with the legislature's intent." The court ruled: "Given these considerations, we find it necessary to look beyond the text of the statute. A review of the background, purpose, and implementation of Proposition 301 leads us to conclude that requiring the Legislature to increase all components of the revenue control limit is necessary because a contrary holding would contradict the intent of the Legislature that drafted the provision and the voters who approved it." The court justified this by using JLBC analysis and publicity pamphlet information which showed the cost of inflating all components of the formula.

In the fall of 2013, the Arizona Supreme Court ruled against the State and remanded the lower court determine the amounts owed to the plaintiffs.

In July 2014, a Maricopa County Superior Court Judge ruled the State of Arizona owed K-12 schools $317 million in new funding beginning in FY2016 but did not rule on how much the state owed in back payments for years in which the Base Level was not inflated. The ruling stated that the Base Level had to be inflated to the level in the next fiscal year as if the inflation measures had occurred in each year the Legislature inflated a different mechanism of the formula instead, creating the $317 million immediate cost. Estimates for the total costs of back payments hovered in the $1.3 billion range. Amazingly, the ruling did not credit the state and taxpayers for any additional increases to the Base Level above the inflationary rate in three strong economic years. The court opined: "Past funding levels do not change the operation of the inflation formula."

The Settlement

In June of 2015, Governor Doug Ducey announced a plan to infuse new money into K-12 schools by increasing distributions from the State Land Trust Permanent Fund. The original ten-year plan called for an increase in distributions from the existing 2.5% to 10% for the first five years and 5% for the following five years. The new funding was described as simply addressing additional resources for classroom spending and that it would not be tied to any reform effort.

Ongoing negotiations between the Legislature and the plaintiffs in the *Cave Creek* lawsuit stalled in the summer of 2015. In October of 2015, the Governor and the plaintiffs announced a negotiated deal that increased K-12 funding to end the lawsuit. The Legislature moved rapidly to pass the settlement bills and refer to the ballot a referendum to alter the State Land Trust distributions. The voters will decide the fate of the lawsuit settlement at a special election on May 17, 2016. The plan adds $3.5 billion over ten years to K-12 public schools and in exchange the plaintiffs agree to drop the litigation with neither side agreeing to past stipulations.

The Details

The settlement borrowed from the Governor's June State Land Trust distribution plan and added several elements which amount to a ten-year funding plan. First, the Base Level amount resets to $3,600- an immediate 5% increase from the FY2016 budgeted level. On top of the Base Level increase, an additional $50 million per year is appropriated from the General Fund through FY2020 and $75 million annually from FY2021 to FY2025. This additional funding is outside the K-12 formula and is not subject to mandatory inflation adjustments and is paid on a pro-rata share based on student count.

JLBC estimates inflationary growth to the Base Level of 1.6% per year. The maximum required by Prop 301 is the lesser of the GDP deflator inflationary rate or 2%, as stated in A.R.S. § 15-901.01. JLBC estimates annual student enrollment growth of 1.4% (See JLBC charts below). Both of these estimates could increase or decrease which would alter the total cost of the plan.

Per JLBC, the net new money for schools in FY2016 resulting from Prop 123 is a fixed amount of $259.3 million (which factors both state and local amounts). The annual increases for the remaining nine years will depend on inflation and pupil growth. The total increase to K-12 revenues from the state including the additional inflation provided during the 2015 regular session provides for a $299 million base increase to M&O funding for FY2016.

JLBC estimates $2.155 billion of the total estimated $3.5 billion in new revenue over the ten-year plan will come from a 4.4% increase in the annual distribution from the State Land Trust K-12 Permanent Fund. This is in addition to the current 2.5% annual distribution for a total of 6.9%. Initial OSPB estimates show $2.056 billion coming from increased distributions from the Trust.

Roughly $800 million comes from the "Additional Inflation" measure created in FY2016. It was originally intended to serve as the "first payment" towards what legislative leadership conceded as a back payment from the *Cave Creek* lawsuit. At the same time, District Additional Assistance was cut by a like amount; therefore JLBC refers to this money as "reallocating current K-12 funding." This revenue stream continues through the ten years growing at 1.6% annually. The remainder of the plan is sourced by the general fund which does not annually inflate and averages $52.5 million per year.

Prop 123				
1	2	3	4	5
Fiscal Year	Base Level Increase	Estimated Cost of Reset	Additional Funds	Estimated Total Increase K-12
2016	173.26	248,829,400	50,000,000	298,829,400
2017	176.03	256,350,000	50,000,000	306,350,000
2018	178.85	264,098,000	50,000,000	314,098,000
2019	181.71	272,080,100	50,000,000	322,080,100
2020	184.62	280,303,400	50,000,000	330,303,400
2021	187.57	288,775,300	75,000,000	363,775,300
2022	190.57	297,503,300	75,000,000	372,503,300
2023	193.62	306,495,000	75,000,000	381,495,000
2024	196.72	315,758,500	75,000,000	390,758,500
2025	199.87	325,302,000	75,000,000	400,302,000
Total		**2,855,495,000**	**625,000,000**	**3,480,495,000**

Source: JLBC

Funding				
A	B	C	D	E
Fiscal Year	Land Trust 4.4% Increment	Additional Inflation	Additional General Fund	Estimated Total Increase K-12
2016	172,081,000	74,394,000	52,354,400	298,829,400
2017	172,444,700	75,584,300	58,321,000	306,350,000
2018	189,936,300	76,793,600	47,368,100	314,098,000
2019	206,008,000	78,022,300	38,049,800	322,080,100
2020	217,929,600	79,270,700	33,103,100	330,303,400
2021	226,484,700	80,539,000	56,751,600	363,775,300
2022	233,291,400	81,827,600	57,384,300	372,503,300
2023	239,723,900	83,136,800	58,634,300	381,495,000
2024	245,760,400	84,467,000	60,531,100	390,758,500
2025	251,526,400	85,818,500	62,957,100	400,302,000
Total	**2,155,186,400**	**799,853,800**	**525,454,800**	**3,480,495,000**

Source: JLBC

THE ECONOMIC TRIGGERS

There are two triggers which suspend the automatic inflation adjustments. If both sales tax revenue and employment grow by less than 2% in the preceding year, the Legislature has the option to fund the inflation adjustment to the Base Level. If both sales tax revenue and employment grow by less than 1%, the Legislature is mandated to suspend the inflation adjustment. According to JLBC, since 1992 the 2% threshold would have been met in six different years while the 1% threshold would have been met in just three instances.

The other trigger built into the proposition relates to the increased distributions from the State Land Trust Permanent Fund. If the five-year average balance of the Permanent Fund falls below the average balance of the preceding five years, the Legislature will reduce the distribution rate to no lower than 2.5%. The trigger would not have been met in any of the last ten years.

Finally, the proposition calls for a trigger which begins in the year following the ten-year funding plan. In FY2026, the Legislature may suspend the annual inflation adjustment and reduce K-12 funding in the next fiscal year in an amount equal to the inflation adjustment if K-12 spending has surpassed 49% of the total state General Fund appropriations. If the total spending surpasses 50%, the Legislature may reduce by double the inflationary amount. In FY2016, K-12 spending from state general fund sources represent roughly 42% of total state general fund appropriations.

Any reduction in appropriation due to any of the triggers being met would not have to be paid back in future years; however, inflationary adjustments continue to compound and the total inflationary increase would be due in the following fiscal year assuming a trigger is not met. Further, any reduction to the base level as a result of the 49%/50% trigger would not become part of the calculation of the base level in future years. While it is a net positive for taxpayers to not have to "pay back" money it never had, compounding inflationary adjustments will certainly prove to be a difficult bill to pay in the years immediately following a recession.

The State Land Trust

In addition to the mandated inflation funding, another undesirable feature of Prop 301 in 2000 was a change to the distributions from the State Land Trust to K-12 schools. Prior to Prop 301, all of the proceeds from the State Land Trust that were distributed to the K-12 schools assisted in funding the Base Level for schools. Prop 301 capped those monies distributed from the Trust that assist taxpayers in funding the K-12 formula at $72 million. The remainder of the distributions to the K-12 schools were "on top" of the formula and paid out on a per-pupil basis. Regrettably, Prop 301 simultaneously imposed a burden on taxpayers to fund both K-12 population and inflation growth without regard to available funds while also stripping taxpayers of any future benefits associated from the growth of the Trust.

The proposed change to the $72 million cap is a significant feature of Prop 123 and one reason why ATRA believes that the temporary draw from the Trust benefits taxpayers in the near term without damaging them in the future. Effectively, the settlement uses Trust funds not currently available to taxpayers to help carry the burden of the court mandated settlement. At the conclusion of the ten-year plan taxpayers will be no worse off as a result of the Trust's reduced funded status because those funds never would have been used to aid taxpayers in funding the ever-increasing burden of the school aid formula.

At the time the Legislature referred Prop 123 to the ballot, the value of the Permanent Fund was $5.16 billion. The fund experienced dramatic growth over the past decade, increasing over 350% since 2004. By February of 2016, the value dipped to $4.8 billion, a gentle reminder of the fund's responsiveness to market forces.

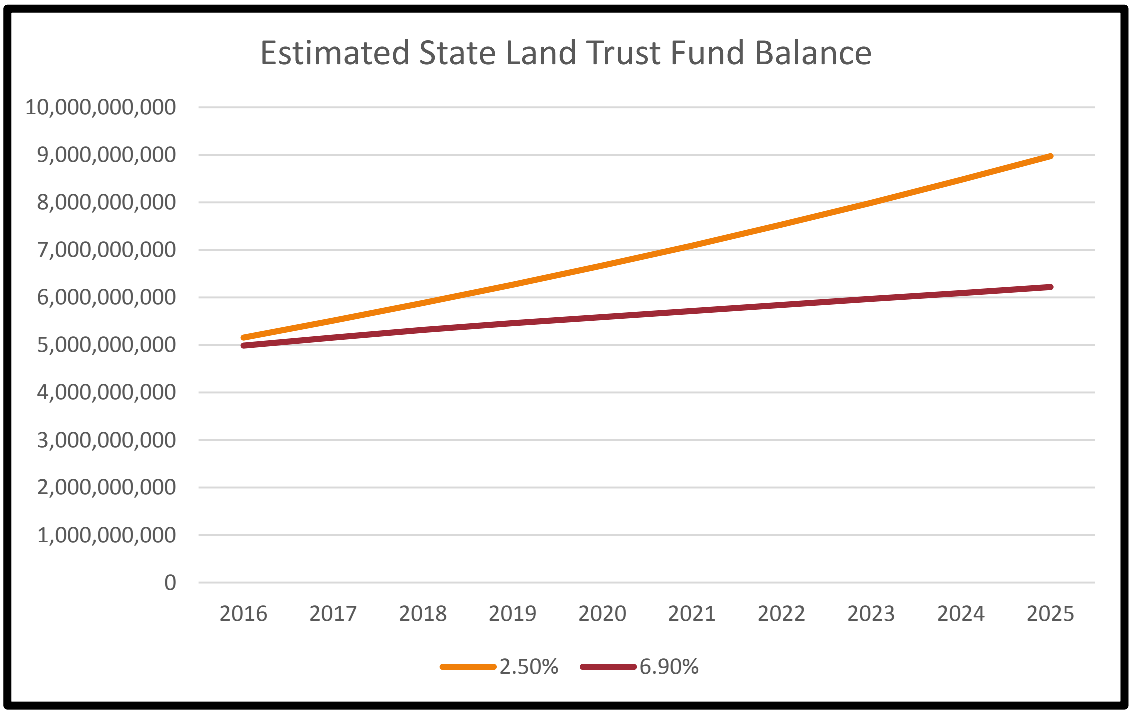
Estimated K-12 Land Trust Fund Balances

Year	2.50% Baseline	6.90% Distribution	Difference vs. Baseline
2016	5,159,835,500	4,987,754,500	-172,081,000
2017	5,515,884,100	5,159,484,900	-356,399,200
2018	5,885,701,400	5,315,634,800	-570,066,600
2019	6,270,122,400	5,457,355,600	-812,766,800
2020	6,671,444,500	5,590,159,900	-1,081,284,600
2021	7,091,533,100	5,718,711,700	-1,372,821,400
2022	7,531,334,000	5,845,459,400	-1,685,874,600
2023	7,991,822,600	5,970,865,500	-2,020,957,100
2024	8,474,007,700	6,095,458,200	-2,378,549,500
2025	8,978,932,900	6,219,605,600	-2,759,327,300

Source: JLBC

State Treasurer Jeff DeWit argues the plan cuts into the corpus of the Permanent Fund and violates basic trust principles. The Treasurer believes that the value of the Permanent Fund does not typically grow fast enough to make a 6.9% distribution without increasing the base by selling state land. Essentially, he argues that instead of spending trust earnings, the plan is dependent on spending the proceeds from land sales. Generic trust theory assumes 6-7% earnings growth depending on the investment strategy and then subtracts roughly 2% for inflation to allow the remainder to be spent on the beneficiaries. This presumes the corpus of the fund is annually reset and previous gains are treated as principal.

Clearly, the intent of Prop 123 is to spend past excess fund earnings for a decade before returning to the more conservative payout of 2.5%, where the fund will have the opportunity to rebuild more robust earnings. It is unavoidable to increase distributions without impacting possible future distributions. JLBC estimates the value of the fund decreasing from a projected $8.9 billion in 2025 to $6.17 billion under Prop 123. The potential future value of the 2.5% annual distribution will decrease by an estimated $70 million in 2025. This presumes average investment growth of 6.9% and annual land sale proceeds of $98 million. No matter the value of the fund in 2025, taxpayers will have to make up the difference between the 2.5% and 6.9% distribution in FY2026 because of the $72 million formula cap in the 2.5% distribution.



Source: JLBC

Property Tax Implications

Because the K-12 funding formula is tied to the local school district property tax, Prop 123 will impact some school district property taxes in two areas. First, roughly 39 school districts fund their operating budgets without receiving any state support. Many of these non-state aid districts have uniquely high property value so their Qualifying Tax Rate (QTR) more than covers the school budget. JLBC estimates the cost of the increase to the Base Level on local property taxpayers in these districts at $20 million annually. A few examples of non-state aid school districts are Cave Creek Unified, Saddle Mountain Unified, Scottsdale Unified and Morenci Unified.

ATRA views this as the expected and regular result of the interrelationship between the school finance formula and local property taxes. Anytime the Base Level is increased by the Legislature in the budget, a non-state aid district will expect to pay more. The annual adoption of the state budget triggers changes to the property tax amounts paid by these non-state aid districts. The formula contemplates the property taxpayer contributing the QTR but if the entire rate is not needed, their rate is lower. They benefit from the formula because their rate is lower than state-aid districts.

Second, property taxpayers should expect increased taxes for M&O overrides for school districts whose voters have authorized them upon passage of Prop 123. M&O overrides are a tax which is based upon a percentage of the Revenue Control Limit (RCL) so as Prop 123 increases the RCL, so too will taxpayer costs for M&O overrides. As a general rule, taxpayers can expect a 5% increase to the amount of their property tax which funds an M&O override. ATRA estimates the increased property taxes for M&O overrides statewide at $20 million. Like the previous provision, this is a formulaic change taxpayers can expect anytime school budgets are increased.

Start Planning Now for the FY2026 Cliff

If Prop 123 passes, state policymakers need to immediately begin planning for the FY2026 fiscal cliff. There will be no excuse to misunderstand the revenue gap, which will be at least $250 million in that fiscal year. Policymakers would do well to develop a soft landing for the General Fund which will require a multi-year planning effort. Lawmakers should begin carving out a space in the General Fund in the next legislative session and plan to grow that amount annually to effectuate a soft landing by FY2026.