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ARIZONA TAX RESEARCH ASSOCIATION

ATRA Opposes Proposition 204

Ballot Box Budgeting:

The State of Arizona is one of 24 states that allow its citizens to legislate through the initiative and referendum process. This powerful tool that provides the citizenry the opportunity to side-step the Legislature has seen considerable use in recent decades. For many years, ATRA has expressed major concerns about the use of the initiative process to circumvent the state budgeting process as well as its impact on public finances in general. This form of *ballot box budgeting*, and the practice of earmarking revenues outside of the appropriations process, has done considerable damage to the state's budgeting process.

Clearly, the most important and fundamental responsibility of the Legislature and Governor is to annually establish budget priorities within available revenues and economic conditions. *Ballot box budgeting* overrides their responsibility and handcuffs lawmakers' ability to respond to the state's changing demands. Furthermore, by circumventing the 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 taxpayer dollars.

In the past, ATRA's forewarnings against *ballot box budgeting* were sometimes dismissed as esoteric or antithetical to the initiative power granted citizens in the Constitution. However, the devastating impact imposed on state finances from the Great Recession has repeatedly vindicated ATRA's strong opposition to this practice.

Further, ATRA believes its opposition to the use of the initiative process for *ballot box budgeting* is entirely consistent with the current restraints on referendums by the Constitution and the Arizona Courts. While the Arizona Constitution provides citizens the power to both propose laws and refer acts of the Legislature to the voters, it specifically limits the authority of the citizenry from referring the annual budget. The framers of the Constitution, while clearly reserving the citizen's right to both enact and reject laws, obviously did not want that power extended to laws "for the support and maintenance of the Departments of the State and of State institutions." In addition, the Arizona Court of Appeals (*Wade v. Greenlee County, 1992*) interpreted this provision to also prohibit citizens from referring a tax increase that was necessary to "support" the state budget.

It is clear that both the Constitution and the courts draw a distinction between policy issues that the citizens can exercise control over through referendum versus budget and tax policy that are best developed through elected representatives at the Capitol. Rightfully so, the framers of the Constitution had specific concern about the state's budgeting process colliding with direct democracy.

The so-called Quality Education and Jobs (QEJ) Initiative is the most complicated earmarking effort to ever be placed before Arizona voters. As the attached ATRA flow chart reflects, there are 12 different earmarks directing money to K-12 education, universities, community colleges, health care, welfare, transportation, adult education, and Joint Technological Education Districts. Because the tax is permanent, the drafters accounted for collections and earmarks that exceed \$1.6 billion.

In addition to the earmarks, the initiative creates mandatory funding floors for the K-12 schools as well as the Universities based on the higher of their FY 2012 or FY 2013 appropriations.

Sales Tax Issues:

Arizona's sales tax system can generally be described as one of high reliance and extraordinary administrative complexity. Arizona has historically always ranked very high in sales tax collections relative to other states (7th in collections/\$1,000 of personal income). Arizona's current average state and local sales tax rate ranks second highest in the country. In addition, as ATRA has consistently noted for years, Arizona's state and local sales tax system is one of the most complicated in the country.

Over the last two years, ATRA has renewed its call for a reform of Arizona's state and local sales tax system. Moreover, ATRA has noted that Arizona taxpayers should not be asked to support a permanent 1-cent increase in the rate without reforms. In addition to simplifying Arizona's state and local sales tax systems, most experts recognize that Arizona's high sales tax rates will continue to produce diminishing returns because Arizonans have ready access to evade those high rates through Internet purchases. Arizona's current sales tax problems are so significant that Governor Jan Brewer recently announced the creation of a Transaction Privilege (Sales) Tax Simplification Task Force to study and make recommendations for improvements.

Simply put, Proposition 204 not only ignores the major problems in the sales tax system in favor of yet another rate increase, it creates a new and major barrier to fundamental reform. In addition to imposing a permanent rate increase, the initiative essentially freezes the current sales tax base with the following provision:

The tax base under this title shall not be adjusted in any manner that causes a reduction to the annual amount collected and distributed under this section to be less than the amount that was collected and distributed in the prior fiscal year increased by six percent unless the reduction in the tax base is offset by a corresponding change in the tax base that effectively results either in no change in the annual amount collected or an increase in the amount collected. On a written request by a legislator, the department shall provide an estimate of the changes or adjustments to the tax base that is contained in proposed legislation that is scheduled for a committee hearing. The department shall electronically provide the estimate to all legislators.

The passage of the Voter Protection Act of 1998 placed strict limitations on the Legislature's ability to make changes to voter approved initiatives. As a result, this provision of the QEJ statutory initiative has the practical effect of a constitutional amendment and will have a significant impact on taxpayers in several ways.

First, legislation that clarifies Arizona's sales tax base will now be significantly complicated by interpretations of whether the legislation does or does not diminish the sales tax base. Over the years, ATRA has successfully advocated for a number of sales tax clarifications to either reverse adverse court rulings or reinterpretations of the sales tax code by the Department of Revenue. In most instances, those were difficult legislative battles that would probably not have been successful in an environment that placed handcuffs on policymakers like Prop 204. Saddled with a requirement to offset a base clarification with a sales tax base expansion or the prospect of legal fight over a potential Proposition 105 violation will all but eliminate the ability of taxpayers to seek sales tax base clarification through the legislative process.

Second, as indicated above, freezing the sales tax base in this manner dramatically increases the degree of difficulty for state policymakers to reform Arizona's state and local sales tax code. National efforts to reform sales tax codes are focused on simplification in order to ease taxpayer compliance. Building an almost impenetrable barrier around Arizona's sales tax base will make it next to impossible for Arizona to change a state sales tax code in desperate need of reform.

School Finance Implications:

Arizona's school finance system is a complicated framework of statutes that is largely designed to provide maintenance and operation and some capital outlay funding to both school districts and charter schools on a per student basis. Major capital funding through general obligation bonds is available to district schools and the laws governing bonding is both constitutional and statutory. District schools also have access to capital funding through the School Facilities Board.

Funding for K-12 schools in Arizona has always accounted for the largest single expenditure of the state general fund. As a result, the myriad of formulas that drive K-12 funding are understandably the subject of considerable legislative scrutiny in the annual budgeting process as well as the respective Education and Tax Committees.

Prop 204 will have a major impact on state policymaker's ability to impact the following areas of school finance:

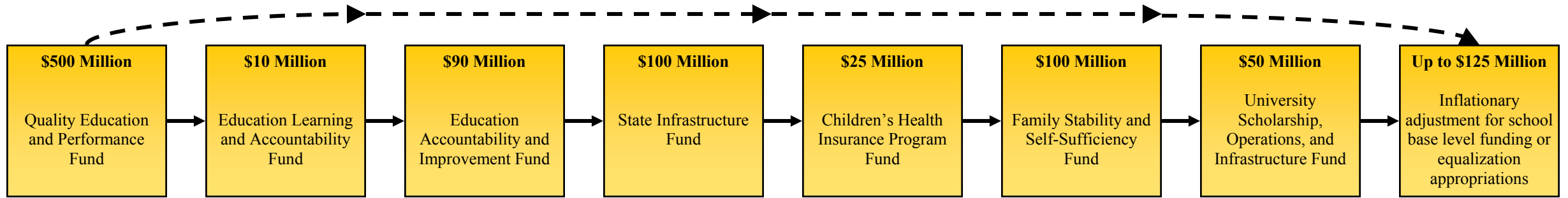
K-12 Appropriations: The initiative creates a permanent floor that cannot be reduced for **both** base support level and the amount appropriated for equalization assistance for FY 2012 or FY 2013, whichever is greater. In addition, the Legislature is required to increase the base support **AND** other components of the revenue control limit (capital outlay revenue limit, transportation support level, soft capital) annually by the lesser of 2% or the GDP price deflator.

As was the case with Proposition 301 in 1998, this portion of the initiative mandates guaranteed maintenance and operation funding increases for K-12 school districts and charters. However, unlike Prop 301, Prop 204 also puts a floor on equalization assistance funding that can never be reduced and only applies to district schools but not charters. The floor on equalization assistance refers specifically to ARS § 15-971, which outlines equalization assistance funding for district schools. Charter schools receive equalization funding through ARS § 15-185.

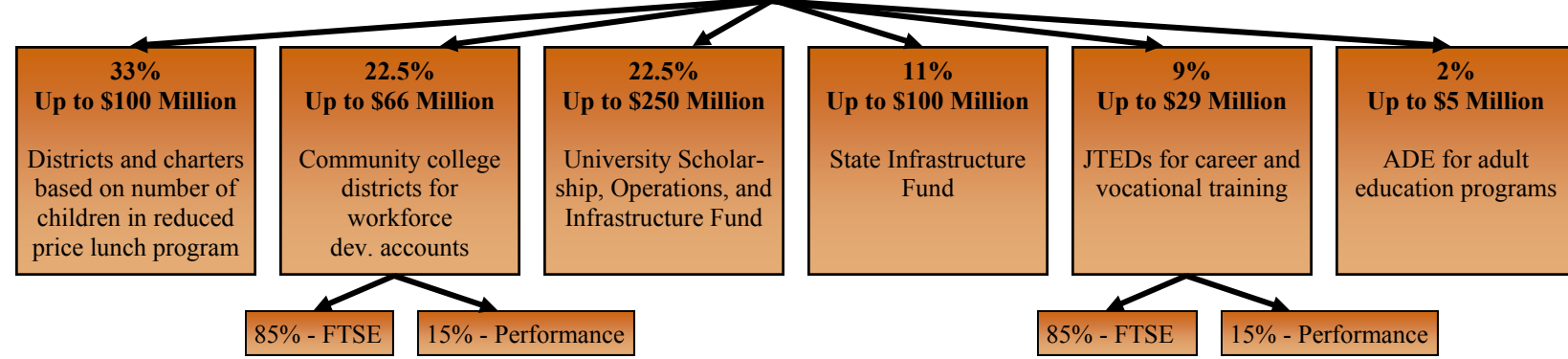
School Finance: In addition to the funding formula mandates for the base support level and equalization assistance never being reduced, Prop 204 also prohibits any reduction to the K-12 debt limits and budget overrides in effect on January 1, 2012. This set of legislative handcuffs could prove to be very problematic in the event that future legislatures need to reform the existing school finance system.

While Arizona's school finance system has been the subject of on-going modifications for decades, it is still the target of much criticism. Currently, the state faces lawsuits from both K-12 districts and charter schools on equity grounds. Clearly, the areas of Arizona's school finance system that creates the most inequity between district schools and between districts and charters are general obligation bonds and overrides. Permanently cementing those two funding streams into the school finance system would make it extremely difficult, if not impossible, for policymakers to react to a court decision that invalidated any of our school financing mechanisms on equity grounds.

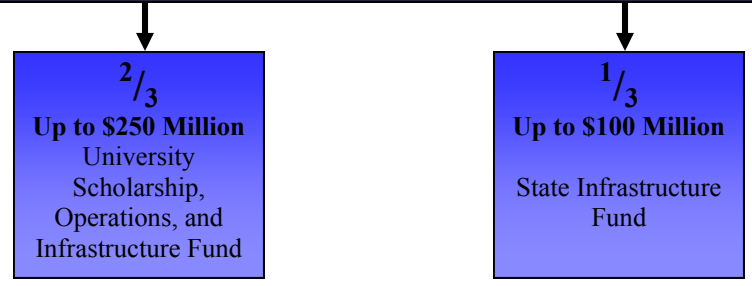
First \$1 Billion Collected



Excess of \$1 Billion Collected



Excess of \$1.250 Billion Collected



Excess of \$1.502 Billion Collected

