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ARIZONA TAX RESEARCH ASSOCIATION

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STATE GF BUDGET CLIMBS 14% FOR FY 2006

FY 2006 grows $1 billion over adopted FY 2005

Bolstered by dramatic revenue growth for the third straight year, the Arizona Legislature and Governor adopted a spending plan for fiscal year (FY) 2006 that adds $1 billion (14%) in new baseline general fund spending over the adopted FY 2005 budget.

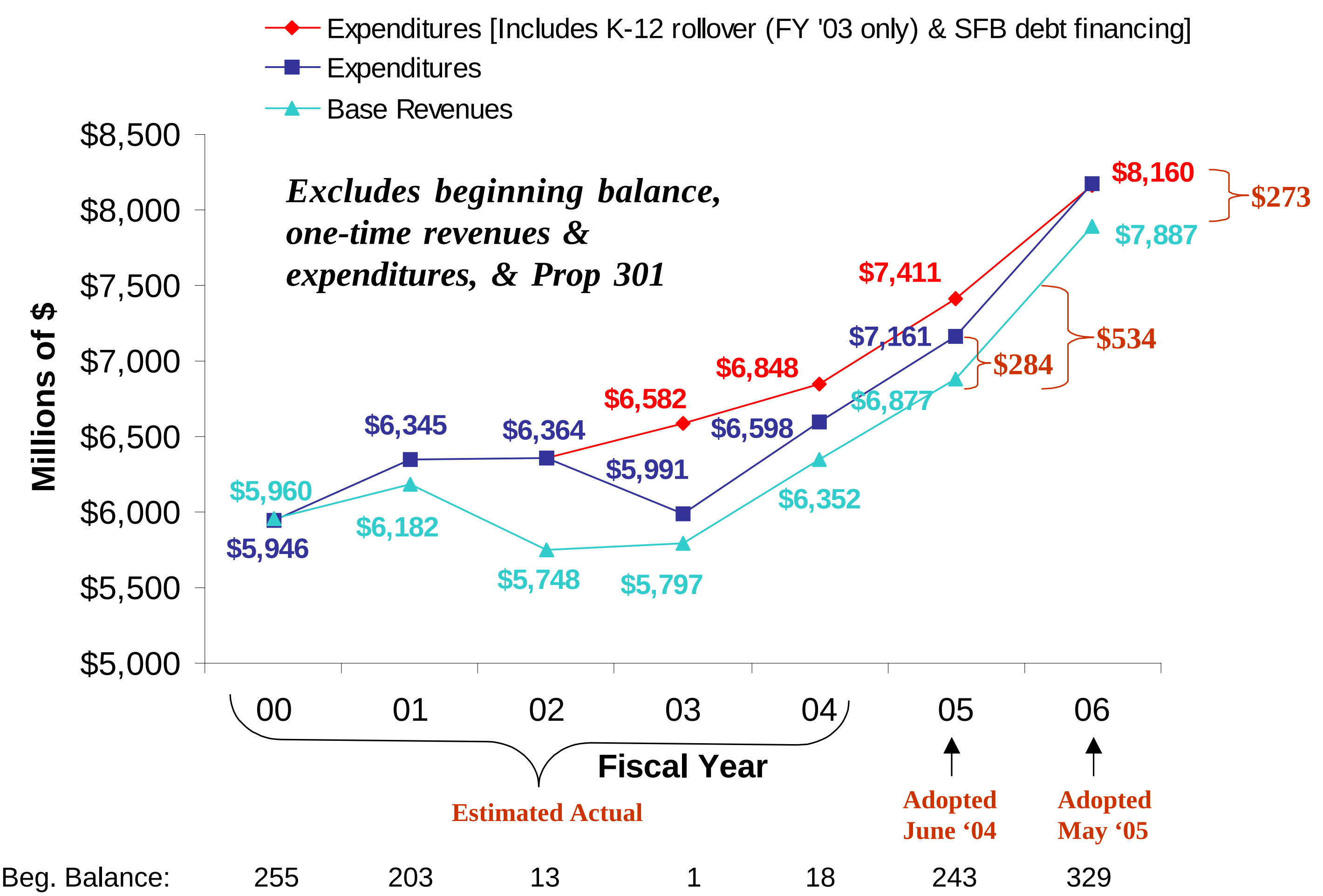
When the new $250 million to cash finance new school construction (which was debt financed in FY 2005) is backed out of the FY 2006 budget, the annual increase drops to 10.7%. Arizona's total state spending authority (general, federal, and other funds) for FY 2006 is $23.7 billion.

THE DEFICIT

As the chart below shows, the adopted FY 2006 still reflects a structural deficit (ongoing expenditures exceeding ongoing revenues) of $273 million. However, that overall deficit was reduced significantly this

See **STATE BUDGET**, page 2

State General Fund deficit declines $261 million



STATE BUDGET

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year as a result of the return to cash financing of new school construction for the School Facilities Board (SFB).

Clearly, the state's effort to return to cash financing new school construction in one year was the major highlight of the FY 2006 budget and the main reason for the reduction in the structural deficit from $534 million in the adopted FY 2005 budget to $273 million in FY 2006.

BUDGET GIMMICKRY

This year the ability of the state to continue to spend at a greater clip than base revenues would cover was accomplished primarily by spending almost all of a $329 million carryforward balance.

In an improvement over recent budgets, the FY 2006 budget lacked the raids and fund sweeps on non-general fund revenues that had become commonplace.

The state continues to "roll over" an outstanding K-12 school payment of $191 million – a gimmick employed in FY 2003 that pushed the final June state aid payment into FY 2004.

MAJOR SPENDING CHANGES

The major winners in the appropriations committees for FY 2006 were the K-12 schools and AHCCCS program.

The K-12 budget climbed 4.9% ($159 million) to fund both student growth and inflation. The budget also included and extra $45 million intended to help offset a 1.7% increase in state retirement system costs.

In addition, the FY 2006 budget reflects another increase in funding for full day kindergarten of $17 million for districts that have 80% or more low-income students.

The AHCCCS budget climbed to over $1 billion as a result of a $118 million increase to fund caseload growth of 43,000 recipients of indigent health care services. Total AHCCCS caseloads are expected to reach 1,126,000 by June 2006.

Funding for universities climbed $47 million, or 5.9%, while community colleges received an additional $8.4 million to fund the college's funding formula.

The budget includes $43 million to fund salary adjustments for state employees. The salary increase of 1.7% offsets the employee share of retirement costs. Taxpayers also had to cover a $23 million increase in the employer's costs for the retirement rate increase.

Larger salary increases were targeted to DPS officers and both juvenile and adult correctional officers.

TRUTH IN TAXATION

For the seventh year in a row, the Legislature adopted the Truth in Taxation (TNT) rates for both the qualifying tax rate (QTR) for K-12 school districts as well as the county education equalization rate (see table below).

Both the QTR and county education rates are statutorily set by the Legislature. TNT requires the state to recognize the growth in statewide property valuations for existing property with a commensurate change in the property tax rates.

A statewide increase in existing properties net assessed values of 4.7% resulted in a 16.82-cent reduction in the QTR and 2-cent reduction in the county education rate. Total statewide net assessed valuation for tax year 2005 will grow 10% of which 4.7% is attributable to appreciation of existing property and 5.3% to new construction.

Since the creation of the state TNT law in 1998, the QTR has been reduced 78.2 cents and the county education rate 9.4 cents.

TEN-YEAR CHANGE

Total general fund spending over the last 10 years has climbed $3.7 billion (81%) from $4.5 billion in FY 1996 to $8.2 billion in FY 2006.

See **STATE BUDGET**, page 3

Reductions in the school district qualifying tax rate and county education rate pursuant to TNT

Tax Year	School Qualifying Tax Rate	Rate Reduction	County Education Rate	Rate Reduction	% Tax Rate Reduction
1998	$4.4000	--	$0.5300	--	--
1999	$4.3308	$0.0692	$0.5217	$0.0083	1.6%
2000	$4.2530	$0.0778	$0.5123	$0.0094	1.8%
2001	$4.1294	$0.1236	$0.4974	$0.0149	2.9%
2002	$4.0592	$0.0702	$0.4889	$0.0085	1.7%
2003	$3.9166	$0.1426	$0.4717	$0.0172	3.5%
2004	$3.7862	$0.1304	$0.4560	$0.0157	3.3%
2005	$3.6180	$0.1682	$0.4360	$0.0200	4.4%

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As reflected in the chart below, K-12 school districts were the recipients of $1.5 billion of that increase, which excludes both Prop 301 monies as well as School Facilities Board appropriations. The largest percentage increase in funding over the last 10 years was in the AHCCCS budget, which rose 146%.

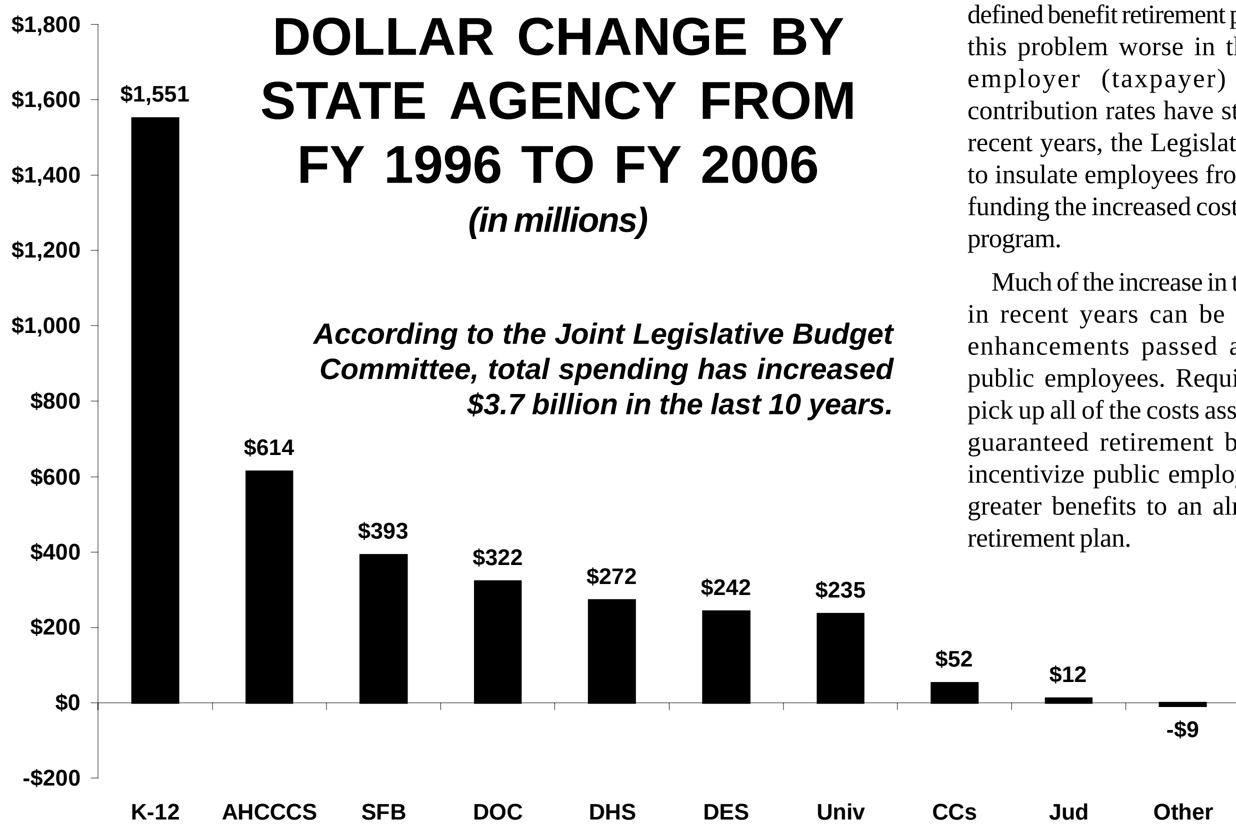
CONCLUSION

As noted, the achieved goal of returning to cash financing for new school construction was a major achievement that deserves recognition. However, the willingness on the part of Legislature and Governor to continue to adopt spending plans that cannot be financed with ongoing base revenues is a significant problem.

ATRA again made numerous recommendations to both the House and Senate Appropriations Committees on how to improve Arizona's financial management (see January 2005 *ATRA Newsletter)*. While a few of the ATRA recommendations were adopted, most were ignored, as any pressure to cut budgets was removed when annual revenue growth topped 14%.

Finally, the Legislature's response to the dramatic growth in the cost of the state's defined benefit retirement plan will only make this problem worse in the future. As the employer (taxpayer) and employee contribution rates have steadily climbed in recent years, the Legislature has attempted to insulate employees from participating in funding the increased costs of the retirement program.

Much of the increase in the retirement rates in recent years can be traced to benefit enhancements passed at the request of public employees. Requiring taxpayers to pick up all of the costs associated with these guaranteed retirement benefits will only incentivize public employees to seek even greater benefits to an already outstanding retirement plan.



Pima County Increasing Special District Taxes

Pima County taxpayers, for years saddled with the highest overall county property taxes in Arizona, now face increases in two countywide special districts this year. Pima County is using the opportunity of a 10-cent decrease in the taxpayer's obligation to pay debt service to increase the property tax rates for both the county library and flood control districts for fiscal year (FY) 2006.

Pima County's net assessed values will climb 8% for FY 2006.

According to Pima County officials, the 6.5-cent increase in the library district rate could be the first of several rate increases necessary to cover the costs of the City of Tucson shifting its library operations to the county. Dumping the library operation is slated to save the City of Tucson budget an estimated $2 million annually. Pima County is in the first year of a five-year transition that will ultimately remove any responsibility from the City of Tucson for the funding and operation of the library.

Pima officials are also planning a two-cent countywide increase in the flood control district rate to finance a 15% increase in that levy. The increase in the flood levy was attributed to a new flood control project on Mt. Lemon.

From the Irony File:

Town of Hayden receives award for demolishing buildings

The League of Arizona Cities and Towns has announced that The Town of Hayden was recognized at a recent Arizona Department of Housing event for their use of FY 2002 Community Development Block Grant (CDBG) dollars "to demolish and dispose of 12 vacant and structurally unsound/unoccupiable residential or commercial structures." The League also reports that the town continued the program in FY 2004 to "demolish six additional structures."

"This not only cleared the community of unsafe structures, but it has opened doors for community revitalization," states the League.

The announcement failed to mention that many structures in Hayden have been vacated as a result of confiscatory property taxation. In fact, the Town of Hayden has been the subject of considerable scrutiny and controversy in recent years for their extraordinarily high tax rates (for more information, see the *ATRA Newsletter* for August 2003, available on the web at www.arizonatax.org).

The combined property tax rate for all taxing authorities in Hayden reached an all time high of $62.55 in 2003. Taxpayers received modest relief in 2004 when $3.2 million was appropriated by the state legislature to restructure the school district's bond debt obligations.

Despite property tax burdens reaching such confiscatory levels, the Town Council in Hayden has continued to increase its tax rate (see graph to the right). Hayden's tax rate was set last year at $23.05 per $100 of assessed value. The rate for 2005 is not yet known.

The primary net assessed value of the district in 1992 was approximately $26.5 million. That value had dropped to $3 million by 2004.

Hayden's remaining taxpayers can only hope that the Town Council will soon realize that the goal of "community revitalization" is more likely to be achieved by reversing the devastating escalation of the tax burden — not by demolishing a few buildings.

A typical scene in Hayden, Arizona

(photo taken by Michael Hunter in 2003)

PRIMARY PROPERTY TAX RATES:
TOWN OF HAYDEN COMPARED TO STATEWIDE CITY AVERAGE