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How to Solve Arizona's Budget Deficit

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Introduction

Over the past decade Arizona's population and economy have grown rapidly, but more recent data suggests this pace is slowing. Today the state is facing the end of its fastest period of revenue and spending growth ever – over the past five years, General Fund revenue collections have grown 52%, while spending has increased by over two-thirds (to $17.8 billion this year).

In October, the Arizona Legislature's Financial Advisory Committee (FAC) – a nonpartisan body tasked with forecasting State revenue collections - projected a cumulative $1.0 billion General Fund cash deficit over the next three fiscal years[i]. The last time the state was in this position was in 2015, following years of tepid revenue growth after the Great Recession and during the peak of K-12 formula funding litigation.

Over the two months since, the state has missed its official budget revenue projections by an additional $205 million, according to the Legislative budget office (JLBC)[ii], and the FAC's spending baseline tends to be on the conservative side. Realistically, given the range of available data and likely trends in both revenues and spending since, as policymakers return from their holiday break and begin the 2024 Legislative session, they are facing a likely shortfall in the range of $1.1 to $1.5 billion.

How did this happen, and how did it happen so quickly? Revenue growth over the past five years has been stronger than ever; as a result, the state amassed record cash surpluses of well over $4 billion by the end of FY 2022. Unfortunately, spending after that took off at unsustainable rates – growing an average of 20% per year in the last two budgets. Policymakers have turned a useful policy tool – one-time funding – into a crutch used to enable large new spending (over $6 billion in just the last two years) on projects of unclear policy value. The result is Arizona's first billion-dollar shortfall in almost a decade.

This report examines these events in greater detail, and how we can course correct.

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The State of the General Fund

According to the October FAC meeting, a combination of small cash reserves and weaker-than-expected revenue growth - even though total General Fund revenue today remains more than $4 billion higher than it was in FY 2020 - has resulted in recurring one-time cash shortfalls being projected over the next three fiscal years. **The cumulative shortfall at the time was an estimated $1.038 billion.**

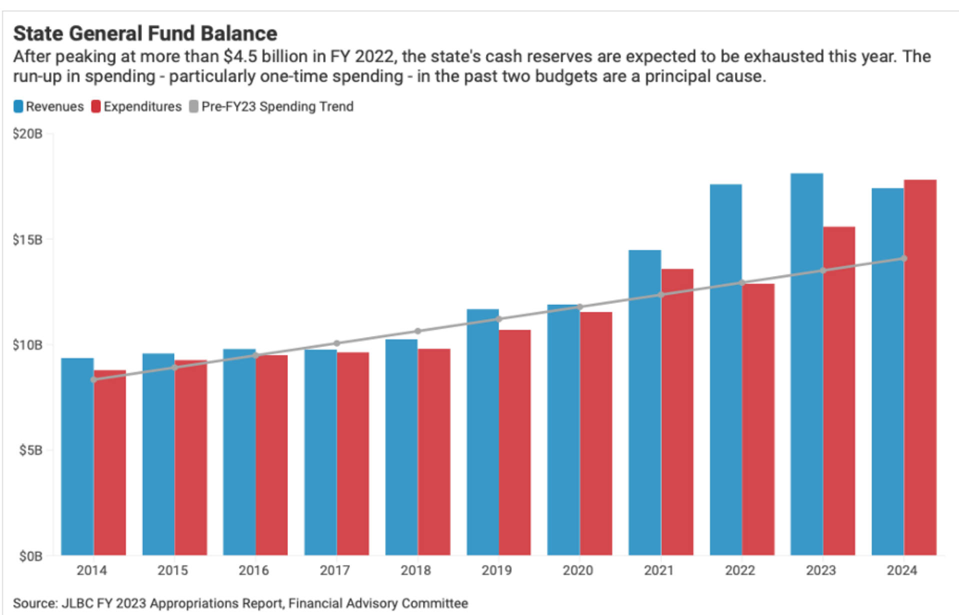
Since then, monthly JLBC updates report revenue growth has continued to disappoint – **the November and December Fiscal Highlights report an additional $200 million in revenue misses.** Legislative fiscal analysts now already project the state is more than $400 million below its officially adopted FY 2024 revenue projections – hitting in five months the revenue miss FAC projected for the entire fiscal year.

Simultaneously, the state faces new spending pressures. The adopted FY 2023 and FY 2024 budgets grew spending by a record $5.0 billion, but increasing shares of this spending are being categorized as "one-time" in nature (including nearly $3.0 billion in FY 2024 alone). Unlike other spending, dollars allocated as "one-time" in an agency budget are not supposed to continue in the next fiscal year (e.g., capital investments in new school buses for state public schools might be "one-time", while per-pupil operating funding is typically "ongoing").

While this means the state continues to be structurally balanced on paper – a marked departure from its historical periods of fiscal instability after the Great Recession – it also creates additional uncertainty. Some of these one-time items are recurring, annual budget inclusions (what JLBC euphemistically refer to as "ongoing one-times" in its October budget presentation[iii]), and others will be difficult for policymakers to successfully back out. Realistically, **demands to continue one-time spending this year could add another $250 million or more to the state's official cash deficit projection.**

On net, considering the state of information available to it, CSI estimates policymakers face a likely cash shortfall of approximately $1.3 billion over the next three years.

Figure 1



How Did This Happen?

Despite brief speculative concern otherwise in mid-2020, the state budget weathered the pandemic period without serious issue. Rapid revenue growth beginning in 2017 only accelerated and spending initially failed to keep pace.

Over the five-year period ending in state fiscal year 2022, revenues increased 80%, while spending grew just 34%. As a result, the state ended FY 2022 with a $4.7 billion cash surplus – its largest ever. Not coincidentally, on a structural basis, too, the budget was historically strong; ongoing revenues exceeded ongoing spending by nearly $4.5 billion at the FY 2022 peak, according to JLBC.

Even today, the state remains on unusually strong structural footing – as of October, the FAC was still projecting a structural surplus of over $300 million despite announcing a three-year cash shortfall of more than $1.0 billion.

What explains this oddity? During the fifteen years between 2002 and 2017, average annual ongoing revenue growth (that's revenue from taxes, fees, and other regular sources) was 3.8%. That is, every year the General Fund could be expected to get a raise of about 4% compared to the year prior; this was enough to basically keep pace with combined growth in Arizona population and inflation.

Expenditure growth over the same 15-year period was likewise restrained; total spending growth (speaking now in terms of both one-time and ongoing spending, combined) averaged 3.2% per year. By 2017, the state was collecting about $9.8 billion in general revenue, and spending $9.6 billion. This was still less revenue and spending than its pre-Great Recession peak of over $10 billion (in FY 2007).

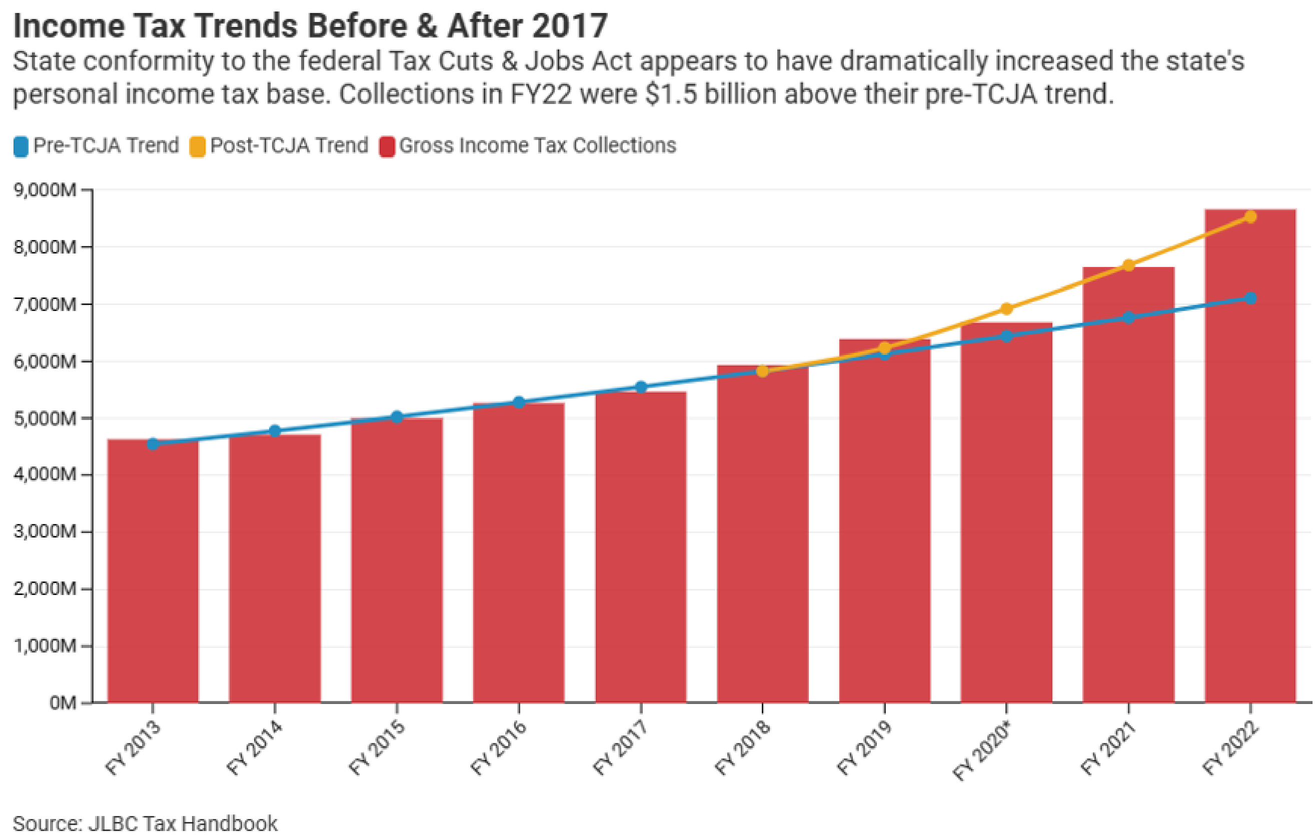
Beginning from and after FY 2017 the revenue picture changed dramatically. Increased tax collections can be attributed to two events:

1. **Arizona's conformity to the federal Tax Cuts & Jobs Act.** Federal tax reform radically redefined "adjusted gross income", which is the starting point for calculating income tax liability. The new definition captures more income.
2. **Arizona's adoption of a "remote sellers" tax.** After the U.S. Supreme Court upheld South Dakota's own version of this sales tax in its *Wayfair* decision[iv], Arizona adopted new laws requiring most only and remote sellers to pay sales taxes on online purchases by Arizona residents.

Over the following five years, annual revenue growth averaged about 13%[1] - despite attempts by the state to offset large tax increases induced by its new sales and income taxes through two rounds of large tax cuts (including most recently moving to a flat 2.50% flat individual income tax in 2023). In half a decade, total resources surged from less than $10 billion in FY 2017 to over $18 billion today; on an ongoing basis, revenue collections today are over $16 billion (an 80% increase over collections in FY 2017).

[1]Average annual revenue growth over the five-year period between FY17 and FY22.

Figure 2



This revenue surge occurred even as individual income taxes fell from five brackets and a top rate of 4.54% in FY 2017 to just two brackets and a top rate of 2.98% last year[2] (among other changes, like a more-than-doubling of the standard deduction).

On the same ongoing basis, the spending side has grown, but growth appears manageable. Over the five-year period between FY 2017 and FY 2022, ongoing spending growth averaged 5.1%. Although the FY 2023 budget spiked ongoing spending by 20% at once, on average, annual ongoing spending growth is still running just 7% since 2017 – faster than its historical trend, but not unmanageable given revenues.

However, what has changed recently is the volume of "one-time" spending. Historically most general spending was ongoing in nature; little attention was paid to the difference between one-time and ongoing or the structural balance. During the Great Recession, though, rapid growth in ongoing spending commitments made it more difficult for policymakers to manage a sharp but temporary drop in revenues; this resulted in ten years of structural imbalance not fully resolved until 2017. As a result, beginning around 2016 the state began focusing heavily on ongoing versus one-time spending and maintaining structural balance. While initially this had the effect of limiting total spending growth and forcing the state to operate within its means, more recently, policymakers have become reliant on the technical classification of new spending as "one-time" to justify its rapid increase.

[2]TY 2024 will be the first year of collections under the new flat 2.50% flat tax.

In FY 2017, of $9.6 billion in total spending, just $250 million was characterized as "one-time" (3% of all spending). This year, nearly $2.9 billion in total spending is being called "one-time" – or more than 16% of the entire state General Fund. Considering both "revenue diversions" and "one-time expenditures", according to JLBC **policymakers have spent more than $6.3 billion on "one-time" initiatives over just the last two fiscal years**[3]. What is it this money has been spent on? In recent years every budget has had a theme or signature spending item, and accompanying policy objective - whether we liked it or not. The FY 2024 budget had no overarching policy goals to accompany its record new spending - instead allocating each member $20-$30 million to spend on projects of choice, ranging from one-time grants of up to $1,000 per classroom for "art supplies" to $5 million to evaluate the medicinal effects of "magic mushrooms"[v].

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This rapid spending growth has grossly outpaced revenue gains (in fact, on an ongoing basis General Fund revenue collections are expected to decline more than $1 billion over the same two years). To make this plan work, policymakers have relied on the states existing cash reserves, built up slowly over ten years of fiscal discipline; **the FY 2024 just-enacted budget left a razor thin projected operating cash reserve of just $10 million in the General Fund (0.056% of total revenue)** – down from a record of over $4.5 billion two years ago and $2.5 billion as recently as last June.

Unfortunately, this reserve is insufficient to buffer an $18 billion budget against normal uncertainty in annual revenue collections. Given long-run data, a reasonable guess for typical annual variance in revenue collections from their expected value (positive or negative revenue surprises) is 1.1%; to absorb that kind of miss in the FY 2024 budget would have required cash reserves of at least $160 million.

Compounding the problem, the reliance on the characterization of any new spending as "one-time" means we risk understating the true scope of the issue, to the extent that some of these commitments are more properly recognized as ongoing. For example, JLBC has flagged health insurance and certain K-12 funding as potentially being "recurring one-times".

[3]This is the sum of roughly $4 billion in one-time spending and $2.3 billion in "TPT diversions".

What Can We Do About It?

Policymakers are now scrambling to fix this problem. To that point – and drawing on our prior experience dealing with precisely these kinds of issues – we have identified a handful of key principles which, if followed, will help resolve the current budget shortfall without any ongoing cuts to essential programs and services and without any new taxes or fees. A return to these historical norms will also protect Arizona's budget on track in the future.

- **Continue the Proposition 123 distributions from the Permanent School Fund into the K-12 funding formula.** When enacted, Proposition 123 was designed to both provide new money to K-12 education and protect the General Fund. The FY 2024 enacted budget assumed these distributions go away, which today are over $300 million a year. Extending Prop 123 – cleanly, without new spending commitments – would both continue to protect both the Land Trust and General Funds, while adding $275 million annually to the General Funds fiscal bottom line compared to the current budget.
- **Identify surplus "other" funds that lie with State agencies.** Every year, policymakers commit billions of dollars of spending in "other" funds outside of the state General Fund. Much of that money starts out in the General Fund, in fact, and is moved into another place (where it often remains, unspent and even gathering interest). Like the General Fund, these other funds can build up substantial cash reserves over time. In 2016 – the last time the state was facing a shortfall – policymakers "swept" $220 million from these funds into the General Fund. Realistically, policymakers can probably find at least $250 million today.
- **Delay or eliminate one-time spending commitments made in the FY 2024 and 2023 budgets, but not yet spent.** Assume that roughly $2.0 billion of the $3.5 billion committed in May for spending over the next two years hasn't yet gone out the door. By our math, after the two solutions above, the state has a remaining cash shortfall of between $600 million and $1.0 billion through FY 2026. By identifying just half of the unspent one-time commitments made in recent budgets that can either be delayed for future years (from or after FY 2027) or canceled altogether, policymakers can resolve the remaining shortfall. For example, some funding for new roads only sped up existing construction plans; those can be returned to their original schedules. Other capital funding is for projects the state may no longer need – for example, upgrades for prison facilities whose inmate populations continue declining.

- **Restore fiscal discipline in the annual budget process.** Finally, policymakers must again restrain annual spending growth. Total annual spending growth. Over the past ten years, the state has prioritized structural surplus and limiting ongoing spending growth. This has worked – in 2015, the last time the state faced this situation, in addition to a $2 billion cash shortfall the state was dealing with $700 million structural deficits. Over the following seven fiscal years, annual spending growth would average just 5.0%/year. Over the past two years, though, spending growth has averaged nearly 20% per year, even as nearly all new spending has been categorized as 'one-time' in nature. Today, though the state remains structurally balanced, it again faces its first projected cash shortfall since 2015. To avoid this going forward, policymakers should strive to tie total annual spending growth to reasonable anchors, like the sum of population growth and the inflation rate (or 4%-5%/year) and try to keep at least 1% of revenue as a cash carry forward.
- **Avoid ongoing cuts to program services and agency operating budgets.** Again, this is a one-time problem created by excessive one-time commitments. The state's ongoing programs are fully funded and remain sustainable. For example, rising costs in the state's ESA program can be offset by savings elsewhere from declining enrollment in traditional K-12 district public schools, since the state's baseline education funding is based on per-pupil formulas. The state's 2.5% flat income tax was phased in over three years and gated behind specific revenue triggers that have been met and exceeded. Cash solutions coupled with a return to fiscal discipline can resolve the current storm without resorting to more structural changes that might lead to years of litigation or debate, as happened after the Great Recession.

After FY 2026, if these steps are followed, the problem begins to resolve itself as one-time spending falls off and annual revenue collections can again begin to more than cover the state's spending commitments. This plan is policy agnostic; it leaves to elected officials the duty of deciding how and where to allocate the state's resources. It simply ensures that they do so within their fiscal means.

REFERENCES

i. "Minutes of the Financial Advisory Committee", Joint Legislative Budget Committee, October 11, 2023.

ii. "Monthly Fiscal Highlights", Joint Legislative Budget Committee, December 2023.

iii. "Finance Advisory Committee Briefing Materials", Joint Legislative Budget Committee, October 11, 2023.

iv. "South Dakota v. Wayfair", Tax Foundation, accessed on Jan. 3, 2024.

v. Pitzl, Mary Jo, "What's in Arizona's state budget?", azcentral, May 10, 2023.