



STATE OF ARIZONA

JANICE K. BREWER  
GOVERNOR

EXECUTIVE OFFICE

June 1, 2009

Dear Citizens:

In my four months as Governor, I have watched with empathy and compassion as our Legislature has labored mightily, during this extraordinarily difficult period, to produce a General Fund budget for the fiscal year that begins in less than 30 days. As I learned during my 14 years as a legislator,<sup>1</sup> meeting Arizona's growing and increasingly diverse funding needs is, even in the best of economic times, one of the most challenging aspects of legislative service.

During this session, the depth of the Legislature's struggles to produce a long-term, comprehensive balanced budget illustrates the severity of the State's mounting fiscal crisis. However, while they have not yet agreed on a budget, our legislators have exhibited courage in addressing the State's immediate fiscal situation.<sup>2</sup> The Legislature's bold actions, in combination with Executive-ordered reductions in the State government's workforce, have helped ease our crushing fiscal burden for the present and will continue to pay dividends in future years.

Nevertheless, the Fiscal Year 2010 budget is due in less than a month, and we are not close to meeting that deadline. The urgency of our mission is magnified by the fact that most current assessments conservatively estimate the FY 2010 General Fund deficit to be roughly \$4 billion, or approximately 40% of last year's General Fund expenditures. With a deficit of this magnitude and historic proportion, only the most decisive and courageous solutions can be considered.

To their credit, legislators on both sides of the partisan and ideological chasm have advocated, in good faith and with good intentions, various budget proposals. Unfortunately, after five months of rancorous discussion, and with only four weeks to go, further debate as to which proposal offered to date is the "right" one is an exercise in futility, for one clear, simple reason: None of them would result in a balanced budget.

Out of respect for our Legislature and its constitutional and time-honored role in spearheading the budget process, I have exercised restraint in engaging the resources and leadership of the

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<sup>1</sup> Governor Brewer was a State Representative from 1983 to 1986 and a state senator from 1987 to 1996. She was the Senate's Majority Whip from 1993 to 1996.

<sup>2</sup> In the January 2009 special session, with less than half of the fiscal year remaining, the Legislature enacted the deepest spending cuts – approximately \$574 million – in state history to help close a \$1.7 billion budget deficit in the current fiscal year. In May 2009, in response to worsening revenue collections, the Legislature made another budget correction to close the FY 2009 shortfall by an additional \$650 million.

Executive branch in moving the Legislature toward an acceptable budget resolution. However, the time for restraint has passed.

Arizona's growing fiscal crisis stands to inflict a devastating impact on our state. We have a non-negotiable duty to adopt a budget that simultaneously addresses, first, our current fiscal situation; second, our future fiscal situation, based on realistic projections; third, the immediate needs of our least fortunate adults and children during this grave economic time; and, finally, our stewardship role on behalf of future generations of Arizonans.

In meeting those standards, the five-point plan<sup>3</sup> that I shared with the Legislature on March 4 provides an even clearer path today.

**1. Budget Reform.** While Arizona's sharp economic decline triggered our budget difficulties, it has been the lack of sound budgetary practices that elevated those difficulties to a crisis. Reforming the State's budget process must encompass (a) changes to the Budget Stabilization Fund<sup>4</sup> (or "rainy day fund"), (b) extending revenue forecasts beyond the current budget cycle, (c) increasing fiscal year ending cash balances, and (d) reducing the rate of spending growth.

*Budget Stabilization Fund (BSF).* The volatile and cyclical nature of the State's revenues sources requires a well-designed "rainy day" fund for use when revenue or expenditure deviations cause a budget shortfall. In 2003, the Citizen Financial Review Committee noted that improvements to the existing rainy day fund are the "single most important change that should be made to Arizona's fiscal system" and that "stability and predictability cannot be achieved without a much stronger Budget Stabilization Fund."

For the BSF to provide adequate protection, the maximum fund balance should be restored to its original level of 15% of actual revenues (from the current 7%). When State revenues exceed historical averages, the excess revenue should be deposited into the BSF instead of being used to fund new programs.<sup>5</sup> When the 15% cap is reached, additional one-time funds should be used to retire outstanding borrowings – including "rollovers"<sup>6</sup> – or to fund one-time capital expenditures. Finally, withdrawals from the BSF must be made only when actual revenues fall below a predetermined level.

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<sup>3</sup> To close what was then a projected \$3 billion budget deficit for FY 2010, Governor Brewer's March 4 "Building a Better Arizona" address to a joint session of the Legislature provided for (1) reforming the budget process, with a focus on longer-term needs and resources; (2) improving Proposition 105 (the Voter Protection Act); (3) implementing a temporary tax increase to generate \$1 billion in additional revenues; (4) reforming Arizona's tax system to attract business and more jobs; and (4) cutting spending by \$1 billion.

<sup>4</sup> The Budget Stabilization Fund, which exists pursuant to A.R.S. § 35-144, provides: "At the end of a fiscal year, the budget stabilization fund balance shall not exceed ... seven per cent ... of general fund revenue for each fiscal year. Any surplus monies above the allowable percentages shall be transferred by the state treasurer to the state general fund.

<sup>5</sup> Specifically, in any fiscal year, any revenues received that are more than 7% of the long-term adjusted rate of growth in General Tax revenues would be deposited into the BSF. By the same formula, if revenues fall below 7%, withdrawals from the BSF would be allowed.

<sup>6</sup> A rollover is a budget-balancing tool by which a portion of a State agency's expenses are "rolled over" into the next fiscal year and included in that year's budget.

*Independent, Longer-Term Revenue Forecasting.* In forecasting revenues, the State can no longer afford to confine its focus to the current budget cycle. The aforementioned revenue and spending estimates for the next four years dramatically demonstrate the need for a longer-term vision. Two-, five- and ten-year forecasts should be produced for each source of major State revenues, and the forecast should be developed with a range of probabilities to reflect economic uncertainty.

As important as the scope of the forecast is the independence of the forecaster. General Fund revenue forecast proposals should be developed under the direction of an independent entity, such as an expanded Economic Estimates Commission.<sup>7</sup>

*Mandatory Cash Balance.* To provide a funding source for unplanned expenditures, General Fund budgets must include a targeted ending cash balance. Over time, the ending cash balance requirement should be increased to 4% of forecasted revenues. Year-end cash balance surpluses would either be carried forward into the next year or used to pay down borrowings and rollovers.

*Renewed State Spending Limitation.* Achieving long-term fiscal stability requires that we reduce both spending and the rate of spending growth.

Consistent with that objective, the current constitutional state expenditure limitation<sup>8</sup> should be replaced with a limit – such as a combined population and inflation formula – that more closely aligns with General Fund revenue sources. Unlike spending limits in other states, our limitation should be computed each year based on the cumulative changes from a base period, instead of being reset from the previous year.

Any amounts deposited and accumulated in the BSF should be exempt from the spending limitation.

**2. Proposition 105.** Our second fundamental problem relates to the permanent, inflexible spending and taxes that are locked into the 1998 Voter Protection Act, also known as Proposition 105. While Proposition 105 was well-intended, Arizona cannot afford to sacrifice core services on the altar of discretionary program enhancements. With respect to budgeting, Proposition 105 paints State government into a corner.<sup>9</sup> Despite passage of the corrective Proposition 101 in

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<sup>7</sup> The three-member Economic Estimates Commission, which exists pursuant to A.R.S. § 41-561, is chaired by the director of the Department of Revenue. Its two other members are appointed by the President of the Senate and the Speaker of the House of Representatives.

<sup>8</sup> Article 9, section 17 The Arizona Constitution restricts the appropriation of certain state revenues to no more than 7.41% of Arizona personal income. The applicable revenues are primarily tax and fee collections that may be deposited to either the General Fund or dedicated funds.

<sup>9</sup> Proposition 105 restricts legislative changes to any voter-approved propositions with a 75% vote of the legislature to further the purpose of the original ballot measure

Measures that Impact General Fund:

Proposition 204, November 2000 – provides AHCCCS health insurance coverage for all Arizonans up to 100% of the Federal poverty level

2004,<sup>10</sup> as a practical matter the only spending cuts available to the Legislature and the Governor are in the critical areas of education, public safety and vital services to our most at-risk population.

The Legislature must send to the voters in the November 2010 election a referendum to require that any initiative or referendum measure that passed between 1998 and 2004 and that enacted a mandatory expenditure of State revenues for any purpose, established a fund for any specific purpose, or allocated funding for any specific purpose, would be subject to a vote of the people to ensure that the measure provided for an increased source of revenues – independent of, and with no detrimental impact on – the General Fund. If the voters do not approve such a referendum on or before December 31, 2012, the Legislature would be authorized to amend the initiative- or referendum-created program.

**3. Spending Cuts.** In my March 4 address to the Legislature, I acknowledged the clear necessity of continued and substantial reductions in State spending. As citizens and businesses throughout the United States are learning to produce and achieve more with less money, so must the government.

Over the last five months, more than 1,200 State employee positions have been eliminated, and over 15,000 State employees have been furloughed. Approximately \$500 million in State spending has been cut, and my FY 2010 budget recommendation cuts State spending by an additional \$600 million. These spending reductions are roughly equal in size to, though different in impact from, budget proposals offered by Republican and Democratic Legislative leaders.

The highlights of my detailed budget proposal include:

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Proposition 201, November 2000 – increases K-12 education funding with 6/10<sup>th</sup> of a cent sales tax increase for teacher pay, lower class sizes, five more school days, and building improvement; higher education funding for workforce development, technology, and research

Proposition 303, November 1998 – appropriates \$20 million from the General Fund each year for eleven years to purchase or lease State Trust Land to preserve it from development

Summary of General Fund Increases - Automatic Spending Increases:

	FY 2007	FY 2008	FY 2009	FY 2010 Est.
K-12	4,156,000,000	4,032,000,000	4,141,000,000	4,339,000,000
AHCCCS	1,132,000,000	1,274,000,000	1,425,000,000	1,751,000,000

<sup>10</sup> Proposition 101 amended the Arizona Constitution (see Article IX, Section 23) as follows:

Section 23. A. An initiative or referendum measure that proposes a mandatory expenditure of state revenues for any purpose, establishes a fund for any specific purpose or allocates funding for any specific purpose must also provide for an increased source of revenues sufficient to cover the entire immediate and future costs of the proposal. The increased revenues may not be derived from the state general fund or reduce or cause a reduction in general fund revenues.

B. If the identified revenue source provided pursuant to subsection A in any fiscal year fails to fund the entire mandated expenditure for that fiscal year, the legislature may reduce the expenditure of state revenues for that purpose in that fiscal year to the amount of funding supplied by the identified revenue source.

- approximately \$1 billion in total State spending reductions – \$400 million for FY 2009 and \$600 million for FY 2010;
- \$100 million for new school construction;
- \$169 million for full funding of K-12 enrollment growth and inflation;
- protection of university funding through the application of federal stimulus dollars;
- restored funding of nearly \$13 million for children support services, including the investigation of all Child Protective Services cases;
- caseload funding growth for the developmentally disabled and for Temporary Assistance for Needy Families;
- filling of critical Department of Public Safety (DPS) officer positions, with no overall reduction in the number of DPS officers, and retention of current funding for the Gang and Immigration Intelligence Team Enforcement Mission (GIITEM) task force;
- continued funding for prison population growth, including the opening of 2,000 new in-state private prison beds targeted for February 2010;
- continued funding for homeless prevention and food operations and rural low-income housing, and no reductions in housing or treatment for the seriously mentally ill;
- the continuation of core environmental quality programs; and
- protection of core construction programs at the Department of Transportation (ADOT), to take full advantage of federal stimulus “shovel-ready” project funding and to prevent harm to ADOT’s bond rating.

Reflecting long-held Arizona values of promoting the well-being and education of our children, the current State budget devotes more than 50% of its funding to education. While my budget reduction proposals for FY 2010 include a necessary reduction of \$295 million in K-12 education funding, that decrease is softened substantially by maximizing the use of federal stimulus dollars. As a result, the net reduction in K-12 education funding is \$73 million.

Slow or negative economic growth invariably raises the demand for – and the cost of – government services. During FY 2009, enrollment in the Arizona Health Care Cost Containment System (AHCCCS) has grown by an estimated 120,700 members, with more than 40% of enrollment growth occurring in the last 60 days. We are unable to change AHCCCS eligibility standards without losing approximately \$1.7 billion in federal stimulus funds. As a consequence, we anticipate that AHCCCS enrollment growth in FY 2010 will have a General Fund budget impact of more than \$250 million.

**4. Temporary Tax Increase.** Ideally, the State’s \$4 billion budget shortfall for FY 2010 would be eliminated without imposing an additional tax burden on Arizona businesses, residents and visitors – particularly at this time, when personal and business incomes are squeezed from every direction.

Unfortunately, after considering *every* option, and after performing a painstaking assessment of our real economic situation, a temporary tax increase is necessary to bridge the gap between fiscal crisis and recovery. Specifically, I am calling for a one percent increase, for 36 months, in the State's transaction privilege tax (sales tax).

It is important to note that this temporary sales tax increase is part of a longer-term tax-restructuring plan that, over the first ten years after enactment (see following section for details), will result in an overall tax reduction.

Taxpayers are justifiably skeptical about promises that a tax increase is truly "temporary." To ease that skepticism, it should be noted that this revenue increase can follow either of two avenues to passage: by Legislative approval or by referendum to Arizona voters. Under either scenario, the Arizona Constitution provides taxpayers the assurance that the tax would remain temporary.<sup>11</sup>

The additional sales tax rate will apply to the existing classifications and exemptions; thus, it will not be imposed on purchases that are not currently taxed by the State. While the tax will not be apportioned with counties and cities under the existing distribution formula, the additional revenues will eliminate the need to transfer hundreds of millions of dollars of the State's deficit to local governments. The tax will be imposed by the Department of Revenue as soon as possible following approval.

I am keenly aware that temporary tax revenues and continuing spending cuts are not the long-term solutions to fiscal stability. Rather, the keys to restoring the balance between ongoing revenues and expenditures are a growing economy, high-value job creation, a slower rate of State spending growth, and, as discussed below, net tax reductions as part of permanent structural tax reform.

**5. Tax Reductions for Economic Growth.** A robust economic recovery is essential to State government's long-term fiscal health. The State's tax structure must promote job growth and sustainability, capital formation, investment in Arizona, and revenue stability.

The first step in providing tax relief to Arizona homeowners and businesses is the phased repeal of the State equalization tax,<sup>12</sup> with permanent repeal occurring proportionately over a three-year period beginning in FY 2010. In the next ten years, permanent repeal will provide tax relief of approximately \$2.2 billion, half of which would directly benefit Arizona homeowners.

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<sup>11</sup> Proposition 108 (passed in 1992) amended the Arizona constitution to require a two-thirds vote by the Legislature when passing any legislation increasing State revenues through a change in tax allocation, such as an increase in taxation levels or a reduction in credits and exemptions. Proposition 105 (passed in 1998) requires a three-quarters vote by the Legislature to amend any approved ballot measure. A constitutional provision authorizing the tax will also include language allowing the tax to be pledged for the purpose of borrowing an amount sufficient to include a full 12 months of revenue in FY 2010.

<sup>12</sup> A.R.S. § 41-1276 provides that the state equalization property tax is levied by the counties on behalf of the State to help offset costs of school districts. The tax rate was set to zero in tax years 2006, 2007 and 2008 and is set in statute to return in tax year 2009.

While Arizona's corporate tax rate is near the median for the nation, the current rate is higher than rates in states with which Arizona competes<sup>13</sup> for business and population growth. Further tax relief should become effective in FY 2012, with a reduction – from 6.96% to 4.55% – in Arizona's corporate income tax rate. This rate reduction is expected to save Arizona employers and economic engines approximately \$250 million per year.

Another competitive disadvantage for Arizona is the tax imposed on business-owned real and personal property. Recognizing this deficiency, the State is already reducing the assessment ratios for commercial classes by 1% per year, from the current 22%. The General Fund budgets for FYs 2010 and 2011 must continue that reduction. For FY 2012 we should evaluate further reductions, with the goal of reducing the assessment ratio to 15%.

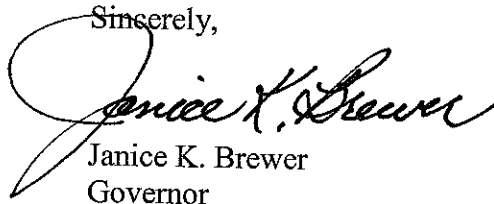
**Conclusion.** My standards for signing the FY 2010 General Fund budget are more steadfast today than they were in early March. I will not sign a budget that relies primarily on debt and federal economic stimulus dollars. I will not sign a budget that incorporates unrealistic spending cuts, excessive gimmicks or phony revenue projections. I will not sign a budget that, in the interest of expediency, dims Arizona's future.

In the preceding paragraphs I have outlined a sensible plan for a balanced budget. It is the only such plan on the table, and I renew my March 4 call to the Legislature to adhere to it closely in fulfilling its constitutional duty.

The clock is ticking – loudly. It is time to come to grips with the fact that a budget that complies with the non-negotiable standards described above will contain elements that are politically and ideologically repugnant and that will create hardships for individuals, families and companies that don't deserve it.

Saving our state from financial ruin in the future requires that we swallow bitter pills now – and that we return our state to a long-term path of recovery.

Sincerely,



Janice K. Brewer  
Governor

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<sup>13</sup> According to the W.P. Carey School of Business at Arizona State University, the ten states that, based on data from the Federation of Tax Administrators, are Arizona's top competitors in attracting new business are California, Colorado, Florida, Georgia, Nevada, New Mexico, Oregon, Texas, Utah and Washington. Of those ten, only California has a higher corporate income tax rate than Arizona.