A RESPONSE TO THE GOLDWATER INSTITUTE'S PROPOSALS FOR CLOSING THE STATE GOVERNMENT BUDGET DEFICIT

A Report from the Office of the University Economist

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In a paper released by the Goldwater Institute on December 18, 2008, "A Fresh Start for Arizona: Proposals for Closing a Billion-Dollar Budget Gap," Byron Schlomach puts forth recommendations for closing the deficit in the state government general fund. Dr. Schlomach should be commended for engaging in this exercise. Closing the state deficit will entail serious considerations as Dr. Schlomach illustrates and an open dialog on this issue is clearly overdue.

The following notes are offered in an attempt to illustrate the consequences of the spending reductions recommended by Dr. Schlomach to close the budget deficit, along with some considerations about the philosophy apparently embodied in the recommendations.

Spending Reductions Versus Revenue Enhancements

In total, the recommendations for spending reductions and fund transfers proposed by the Goldwater Institute account for just more than $1 billion. For perspective, general fund appropriations for 2009 are nearly $10 billion — less than in 2008 on a nominal basis and less than in 2007 considering population growth and inflation. (All references to years are the fiscal year; e.g. fiscal year 2009 runs from July 1, 2008 to June 30, 2009.) Ongoing general fund revenue (excluding "one-time" sources of funds) for 2009 currently are projected to be slightly less than $8 billion and are not expected to be much more in 2010.

Thus, if spending cuts alone are to balance the budget in the current and following years, permanent spending reductions will need to be twice the amount listed by Dr. Schlomach. Since some of the recommendations in the Goldwater Institute paper result in the complete elimination of certain programs, the next $1 billion of spending reductions that will be needed to deal with the structural deficit will invariably expose other programs to much larger cuts than identified.

Proponents of budget balancing through budget cuts need to consider Dr. Schlomach's list carefully. Some of the suggestions may subject the state to court challenges, while others will result in the loss of significant federal matching dollars at a time when demand for the programs is high. Some highlights follow:

- A recommended $210 million reduction in state spending for Arizona's Medicaid program (AHCCCS) would put the state out of compliance with existing contracts with providers and would be subject to litigation. Further, it would trigger an additional $400 million in federal matching reductions, so it actually represents more than $600 million in reduced spending for indigent health care.
- Eliminating full-day kindergarten runs counter to considerable literature that suggests that early childhood education is one of the best investments available in public education. It will also cause undue hardship for young working families who will have to seek additional day care for their children.
- A $100 million reduction in university spending will result either in lower-quality education or higher tuition. It comes at a time when economic development advocates are suggesting that universities are important drivers of "knowledge economy" growth.
- A $95 million reduction in corrections (about 12 percent of the corrections budget) could result in the release of about 12 percent of the prisoners currently incarcerated.

- The $61 million in reductions to the Department of Health Services represent monies negotiated in a court settlement. This would result in a similar reduction in federal matching funds.
- Spending cuts recommended for the Department of Economic Security sum to about $100 million and most are matched by federal funds, resulting in additional lost federal aid for the state.
- The uses of lottery funds are subject to Proposition 105, passed in 1998, that states that the Legislature cannot amend statutory language in ballot propositions. Thus, the recommended lottery transfer of $50 million to the general fund may not be possible.
- The recommendation to "reduce additional state aid by 10 percent" ($40 million) implies reducing the homeowners rebate. This is a program in which the state pays a portion (about 38 percent) of each homeowner's school district primary property taxes. Effectively, this proposal would increase the property tax on residential homeowners.

Dr. Schlomach does not include revenue enhancement in his list of recommendations because he states that "taxes reduce economic activity, punishing productivity, innovation, and hard work." However, spending reductions achieved through the scaling back or elimination of government programs and reductions in the public-sector workforce also will reduce economic activity — by approximately the same extent. Such reductions will punish the productivity, innovation, and hard work of those employed in the public sector. Indeed, Dr. Schlomach lauds the Arizona Joint Legislative Budget Committee (JLBC) staff members who "were very helpful and professional in responding to his inquiries" in assisting his work on his paper.

Further, the proposed spending cuts will adversely affect productivity, hard work and innovation in the private sector of the economy. The vast bulk of state government spending ends up in the private sector in Arizona, either through the direct purchase of goods and services by state government, or by the purchase of goods and services by state government employees.

The result of state government spending cuts of $1 billion would be to very significantly worsen and lengthen the economic recession. A total of approximately 20,000 workers — 8,000 state government and university workers and 12,000 others — might lose their jobs. Note that the aggregate impact on the private sector is greater than that on the public sector.

Closing the budget deficit, as required by the Arizona Constitution, will result in economic hardship regardless of whether the balancing is achieved through spending cuts or tax increases. The aggregate effect will be about the same regardless of the method used. The effect on particular individuals and businesses, however, will vary widely with the method selected. Spending cuts place the burden primarily on a relatively small number of state workers and of companies that sell directly to state government or to state employees. Those individuals and businesses that rely on state programs that are scaled back or eliminated also will be affected, perhaps severely. In contrast, revenue enhancements that spread the impact across the state's more than six million residents and hundreds of thousands of companies will likely have only a minor effect on any individual or company, with the exact impact depending on the types of revenue enhancement that are adopted.

It is economically undesirable to consider either tax increases or spending cuts during a severe economic downturn. But Arizona policymakers have never timed tax reductions or increases with any consideration for the business cycle. Taxes were increased in 1990 during a recession and were significantly reduced during the mid-to-late 1990s and mid-2000s economic expansions. So, Arizona policymakers have cut taxes at economic cycle peaks and have raised taxes in a recession. The period of tax increases around 1990 was followed by the longest and strongest period of economic growth in the state's history. Had the tax structure that prevailed in 1995 been left intact, with any annual surpluses deposited in the budget stabilization fund or returned to taxpayers in one-time rebates, Arizona would not be facing a budget deficit today.

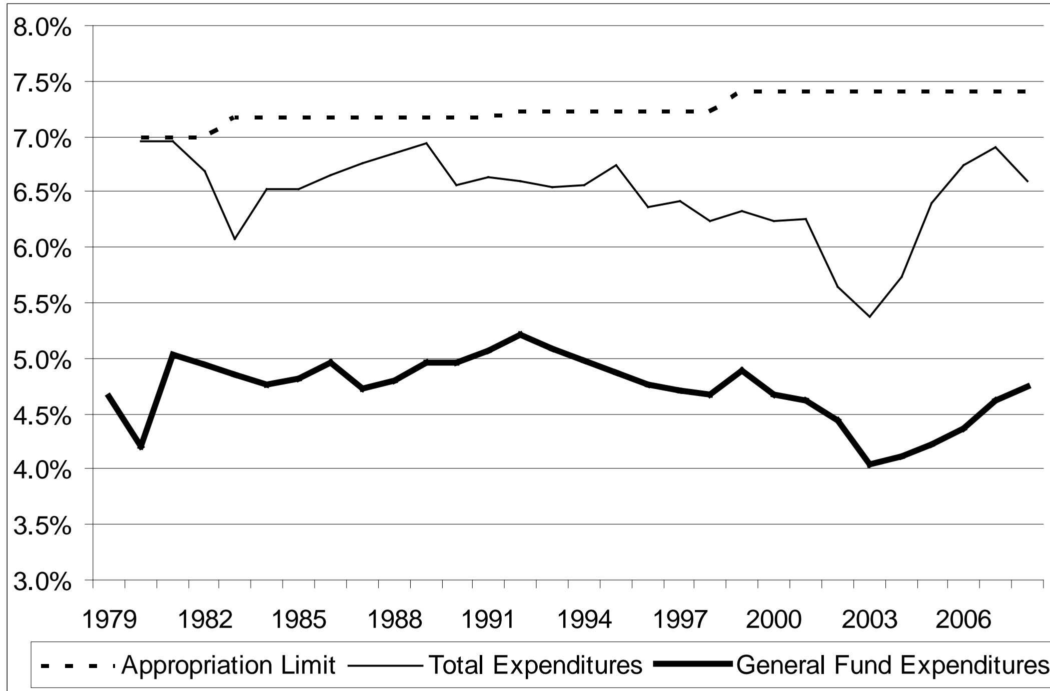
The Goldwater Institute justifies its focus on spending reductions based on "dramatic increases in spending in recent years." These "dramatic" increases followed years of spending decreases that were even more "dramatic." Spending, relative to the growth of the state's economy, had been falling since 1992, and then in order to balance the budget in the last recession without enhancing revenue, the Legislature reduced spending significantly more in 2003, to an unprecedented low level. A recovery in spending naturally occurred after this, facilitated by the surge in government revenue that occurred during the economic expansion, which was in part due to the real estate boom.

Even at the peak in 2008, general fund expenditures as a share of the economy were less than in the majority of the preceding 29 years (see Chart 1). Fully closing the general fund deficit in the current and following year by using only spending cuts will reduce the size of the general fund to about 3.6 percent of the state's economy, as measured by personal income, in 2010. This would by far be the lowest level on record. In most years, general fund expenditures have been between 4.5 percent and 5 percent of the state's personal income, and total expenditures as defined by the constitutional appropriation limit have been comfortably below the limit.

Given the timing — already halfway through the fiscal year — it is not likely that revenue enhancements alone will be enough to close the deficit in 2009. (The wildcard is whether the federal government will provide "bail-out" funding to state governments in the coming months.) Thus, a sizable proportion of the type of spending cuts identified by the Goldwater Institute likely will need to be considered. Tax increases and other revenue enhancements, however, would preclude the need to cut deeper than indicated in the Goldwater Institute report before the economic down cycle is over.

The last sentence of the Goldwater Institute report states that "spending cuts today are key to creating opportunities for real economic growth to occur in the future." There is no empirical basis for this statement. Arizona has experienced tax increases and tax cuts, with associated changes in government spending, over the last 30 years. The state has grown rapidly with no perceptible effect on economic growth following any changes in the tax code. Certainly, excesses in the public sector coupled with high tax rates and an excess of regulations can stifle private-sector growth. But there is NO evidence that Arizona exhibits these tendencies, even if modest revenue enhancements designed to address the budget situation were adopted. There are plenty of opportunities for economic growth and prosperity in Arizona over the coming years and those opportunities will prevail even if the state's taxpayers face average tax burdens rather than tax burdens among the lowest in the nation, as is currently the case.

CHART 1
EXPENDITURES AND CONSTITUTIONAL APPROPRIATION LIMIT AS A PERCENTAGE OF PERSONAL INCOME, 1979 THROUGH 2008, ARIZONA STATE GOVERNMENT GENERAL FUND



Sources: Arizona Joint Legislative Budget Committee (expenditures and limit) and U.S. Department of Commerce, Bureau of Economic Analysis (personal income).

A three-volume set of reports produced by the Office of the University Economist takes a much more in-depth look at the issues noted above and at public finance in Arizona in general. The first volume provides the empirical data, the second volume addresses the relationship between taxes, government revenue, and economic growth, and the third volume presents options for managing the state government general fund.

Spending Limitations

Throughout Dr. Schlomach's paper, a comparison between observed state spending and the pace of population growth plus inflation appears. The underlying argument is simple: If spending exceeds the pace of population growth and inflation, there must be "too much spending."

This argument can be traced to rhetoric disseminated by the Cato Institute that has found its way into the arguments of those who seek to minimize the size of the public sector. Aligning the pace of population and inflation to some measure of the "need" for government ignores productivity growth, which causes inflation-adjusted per person income to rise over time at an average of 2 percent per year. It also ignores the Arizona Constitution, which ties state government appropriations to personal income: a combination of inflation, population growth, and real per person economic growth.

Restricting government expenditure growth to the pace of population and inflation will result in growth that lags the economy by about 2 percent per year. This has predictable consequences over long periods of time. Assume that the economy grows at an average nominal rate of 7 percent (including inflation and population growth) per year over 100 years and that government spending is restricted to 5 percent per year growth (inflation and population growth) over the same period. If government spending at the beginning of the period is 5 percent of a state's economy, at the end of 100 years, government spending would be only 0.76 percent of the size of the economy!

Had this spending restriction been adopted in 1908, Arizona's physical infrastructure and other public services in 2008 would resemble those of 1908: dirt roads, school houses with outdoor restroom facilities and no computers, no modern communication, etc. While roads, schools and other infrastructure would be much more numerous, spending restricted to inflation and population growth does not allow for any improvements. Not allowing the public sector to grow commensurate with the pace of technological change is especially ironic since many of the technological improvements during the last century took substantial public funds to make them a reality.

Empirically over any reasonable time period, in NO state has government spending grown only at the pace of inflation and population growth. Using public finance data compiled by the U.S. Census Bureau, which is much more inclusive than the state general fund, spending for each of the 50 states was examined between 1992 (a government census year) and 2006 (the latest year available). The change in spending between 1992 and 2006 first was controlled for inflation, using the gross domestic product implicit price deflator, and then adjusted for population growth, as estimated by the Census Bureau. This real per capita change is shown in Table 1.

In every state, real per capita growth was positive, measured both as the expenditure growth of state government only and of combined state and local governments. Arizona ranks among the bottom 10 states on both state government and combined government spending increases, with gains of around 2 percent per year at the state level and 1.6 percent at the combined state and local level. So, Arizona state government spending has exceeded growth in population and inflation by about 2 percent per year while spending in excess of population growth and inflation was 2.5 percent or more per year in the majority of states. The evidence suggests that demands on the public sector regularly require government spending to grow faster than the pace of population and inflation.

Table 1 also compares government spending increases to economic growth. Adjusting expenditure growth for real per capita economic gains as well as inflation and population reveals that spending in Arizona fell between 1992 and 2006. Arizona was one of 11 states with a negative figure for state government spending and one of 13 states with a decline in combined government expenditures. Looking at a smaller group of states — those in the West and/or fast-growing — Arizona's spending adjusted for inflation, population growth, and real per capita economic growth ranked 11th of 13 in state government and 12th of 13 in combined state and local government (only Nevada was lower).

Since the state government general fund is the focus of the Goldwater Institute report, general fund expenditures from the JLBC also were examined. Over the same 1992-to-2006 period used for the Census Bureau data, state general fund spending rose only 0.9 percent per year adjusted for inflation and population growth and decreased 1.3 percent per year adjusting for real per capita economic growth as well. Both figures are considerably lower than those calculated from the Census Bureau's broader definition of state government expenditures. The difference stems from the inclusion of capital outlays and spending in other funds in the Census Bureau's data.

Bringing the JLBC spending data up to date, between 1992 and 2008 state general fund spending rose only 1.3 percent per year adjusted for inflation and population growth and decreased 0.6 percent per year adjusting for real per capita economic growth as well. Based on conservative fiscal year projections of inflation, population growth, and nominal gains in total personal income (1.5 percent, 2 percent and 3.5 percent respectively), and assuming that 2009 spending matches the originally budgeted appropriations, the annual average expenditures for the 1992-through-2009 period will be even lower at 0.9 percent after adjusting for inflation and population and -0.8 percent after adjusting for real per capita economic growth as well.

If $1 billion in cuts, as proposed by Dr. Schlomach, were imposed in 2009, these 1992-through-2009 annual average growth rates would drop to 0.3 percent adjusted for inflation and population growth and -1.4 percent adjusting for real per capita economic growth as well. If spending were decreased $2 billion to match the ongoing revenue projection, the average annual rate of spending would be -0.4 percent adjusted for inflation and population and -2.1 percent after adjusting for real per capita income growth as well. Spending in this case would be 3.6 percent of personal income — a historical low.

The empirical data indicate that Arizona policymakers have not "overspent" from the state's general fund. Instead, the existing deficit results from a combination of very substantial tax reductions, a severe economic downturn, and an inadequate amount of money being placed in the state's rainy-day fund.

Conclusion

The case for solving the budget deficit exclusively through budget cuts ultimately rests on the simple notion that many types of government spending are unnecessary — not that current levels are too high. Decisions on the necessity of state funding should have been made at the time that tax cuts were implemented, not years later in the midst of a major economic downturn. A public discussion at that time would have increased the transparency of public decision making and made the cost of tax cuts obvious to the public. If the ultimate decision would have been to cut spending, then those adversely affected would have been in a much better position to find alternatives than in the midst of a recession.

Thus, a true discussion is long overdue on whether state government spending for schools, universities, health care, public safety, and other programs is needed at all, because that is at the heart of the budget cutter's arguments. The citizens of Arizona should ultimately decide, but they need facts presented in an unbiased manner with which to base their decisions.

TABLE 1
CHANGE IN GENERAL EXPENDITURES BETWEEN 1992 AND 2006

	State Government				State and Local Government			
	Annual Average Real Per Capita Spending		Annual Average Real Per Capita Spending Relative to Real Per Capita Income Growth		Annual Average Real Per Capita Spending		Annual Average Real Per Capita Spending Relative to Real Per Capita Income Growth	
	Change	Rank	Change	Rank	Change	Rank	Change	Rank
United States	2.58%		0.64%		2.38%		0.45%	
Alabama	3.03	14	0.94	19	3.44	3	1.34	6
Alaska	0.55	50	-0.61	46	0.22	50	-0.94	50
Arizona	2.03	41	-0.12	40	1.64	45	-0.50	46
Arkansas	3.76	2	1.76	5	3.45	2	1.45	3
California	3.10	13	1.17	11	2.57	22	0.65	18
Colorado	2.22	37	-0.18	43	1.90	40	-0.49	45
Connecticut	1.79	43	-0.42	45	1.80	43	-0.41	44
Delaware	3.41	9	1.67	7	3.14	5	1.41	5
Florida	3.60	5	1.48	9	2.72	16	0.61	21
Georgia	1.84	42	0.09	39	1.98	38	0.22	30
Hawaii	0.77	49	-0.14	41	0.64	49	-0.27	41
Idaho	2.62	27	0.57	25	2.45	30	0.40	27
Illinois	2.25	35	0.49	30	2.52	25	0.75	16
Indiana	2.47	32	0.78	22	2.82	13	1.13	9
Iowa	2.91	19	0.97	18	2.56	23	0.63	19
Kansas	2.83	23	0.97	17	2.61	18	0.76	15
Kentucky	2.70	25	0.90	20	2.47	26	0.68	17
Louisiana	2.37	33	1.05	13	2.45	29	1.13	8
Maine	3.74	3	1.74	6	2.95	10	0.97	11
Maryland	2.69	26	0.50	29	2.59	20	0.40	26
Massachusetts	2.83	22	0.39	32	2.83	12	0.39	28
Michigan	1.77	44	0.33	33	1.88	41	0.44	24
Minnesota	2.50	29	0.28	36	1.58	47	-0.62	49
Mississippi	4.64	1	2.30	1	3.94	1	1.62	2
Missouri	3.45	8	1.76	4	3.09	6	1.41	4
Montana	2.97	16	0.80	21	2.29	33	0.13	32
Nebraska	3.11	12	1.12	12	2.60	19	0.63	20
Nevada	1.27	47	-0.75	48	1.42	48	-0.61	48
New Hampshire	0.83	48	-1.21	50	1.68	44	-0.38	43
New Jersey	2.10	39	0.12	38	1.96	39	-0.03	38

TABLE 1 (continued)
CHANGE IN GENERAL EXPENDITURES BETWEEN 1992 AND 2006

	State Government				State and Local Government			
	Annual Average Real Per Capita Spending		Annual Average Real Per Capita Spending Relative to Real Per Capita Income Growth		Annual Average Real Per Capita Spending		Annual Average Real Per Capita Spending Relative to Real Per Capita Income Growth	
	Change	Rank	Change	Rank	Change	Rank	Change	Rank
New Mexico	3.53	7	1.43	10	2.97	9	0.88	12
New York	2.19	38	0.30	34	2.09	35	0.20	31
North Carolina	3.61	4	1.78	3	3.05	7	1.23	7
North Dakota	2.24	36	-0.17	42	2.19	34	-0.22	40
Ohio	3.30	10	1.80	2	3.27	4	1.77	1
Oklahoma	2.89	21	0.54	28	2.37	31	0.03	36
Oregon	2.09	40	0.29	35	1.86	42	0.06	35
Pennsylvania	2.48	31	0.67	23	2.58	21	0.77	14
Rhode Island	1.41	46	-0.65	47	2.03	37	-0.04	39
South Carolina	2.99	15	1.02	15	3.02	8	1.05	10
South Dakota	2.49	30	0.15	37	2.36	32	0.02	37
Tennessee	2.36	34	0.43	31	2.46	27	0.52	23
Texas	2.92	18	0.56	26	2.46	28	0.11	33
Utah	3.21	11	1.02	14	2.55	24	0.38	29
Vermont	2.89	20	0.62	24	2.67	17	0.40	25
Virginia	2.81	24	0.54	27	2.86	11	0.59	22
Washington	1.63	45	-0.34	44	1.61	46	-0.36	42
West Virginia	3.54	6	1.65	8	2.72	15	0.85	13
Wisconsin	2.97	17	1.02	16	2.04	36	0.11	34
Wyoming	2.54	28	-0.84	49	2.80	14	-0.58	47

Source: U.S. Department of Commerce, Census Bureau (expenditures and population) and Bureau of Economic Analysis (personal income and GDP implicit price deflator).