

Achieving a New Era of Fiscal Responsibility in Arizona

By Hugh Hallman

Arizona's fiscal situation is in an unprecedented state of crisis. Budget deficits are skyrocketing as tax revenues plummet. Drastic cuts to budgets are not just being considered, they are necessary. Our Republican governor has even gone so far as to anger her own constituent base by proposing a tax increase.

And most recently, the Republican Legislature came out of a long-series of backroom meetings with a plan that would balance the state budget on the backs of school districts, cities and towns — effectively taking money out of our neighborhoods to pay for the state's failure to plan as cities like mine have had to do all along. All the options on the state's table are bad, but raiding neighborhoods to balance the state budget is particularly onerous, as is a tax increase.

So how did we get here and how do we fix the problem?

There is certainly a dearth of ideas on how to address the problems the state faces. Balancing a budget is about a lot more than raising taxes and cutting expenditures — it requires a comprehensive approach to fiscal responsibility, one that looks at a variety of approaches and recognizes ways to leverage resources in a way that meets both short-term and long-term needs.

What do I know about this? As the Mayor of one of Arizona's most dynamic cities — one that, while also feeling the effects of the economy, is faring far better than most municipalities — I have some thoughts on these topics. I also have a background in both economics and law, so I understand the challenges our state's leadership is facing.

I appreciate how difficult it must have been for Governor Brewer to propose a tax increase, and respect her willingness to put her political future on the line. I also respect the enormity of the challenge being faced by the state Legislature. This crisis has been laid at their collective feet due to the failure of the prior governor and legislators to be honest about the challenges our state faced and to deal with those challenges in a timely fashion.

I offer a few suggestions here, not because I believe I have all the answers, but because I believe there's a need to change the focus of the debate away from "Are we raising taxes?", "Which programs are we cutting?" and "Can we play games with the numbers or rob Peter to pay Paul?" to a new direction — "How do we develop a fiscally responsible plan for solving our current problems while planning for a stable future?"

There are three components to building a fiscally strong State government that have been ignored for too long. First, our State should take a lesson from local governments on how to pick and fund capital projects that provide value for our future. Second, we need to build and maintain a sufficient reserve for the bad times. And third, our budget leaders need truly to understand the difference between recurring and one-time revenues and expenses.

Changing the way we finance state capital projects

First, there's one principle we might be able to use in the short-term to help lessen the need for severe budget cuts or raise taxes at the worst time. The principle is required of cities in the State of Arizona, by long-time State policy. What's been good to keep cities fiscally responsible would help the State too.

If you have been diligent or lucky enough to be able to buy a house, you recognize that you are borrowing from your future when you commit to a mortgage payment. The same is true if you borrow to buy a car. That monthly payment will roll around and, if you don't make the payment, you lose the house or the car. Once you make that commitment, you know that a certain portion of your monthly income has to be set aside long into the future to make your payments.

We make these kinds of choices because we know that the car or house will bring us value in the future. The car helps one get to and from work to make the money for the car and everything else that costs money. A house is the kind of "expense" that can, during most times in our country's history, act as a kind of "investment" that will give us and our family shelter and a kind of "savings" account for ourselves or those that inherit from us. We borrow money and pay not only what we borrowed, the principal, but also interest on the money we've borrowed. That interest is the cost we pay to use someone else's money now to get something we'll use now and in the future, when we're making those payments. That makes sense for us and for our State.

Yet, we have failed to identify, except in a few special cases, those things we are buying as a State and be sure we spread the payment for those things over the time they will be useful to us. We often pay "cash" for such things and, as a result, use a great deal of a current year's "recurring" funds for a long-term asset.

This seems to happen for a couple of reasons. First, fiscal conservatives don't trust fiscal liberals with any multi-year agreements for long-term funding. That is, fiscal conservatives fear that if today's money isn't used for long-term investments now, it will go to adding programs that have annual costs and the long-term investments never will get made. Further, some fear that all kinds of assets will be categorized as "long-term" and will be thrown into the "capital" funding cycle to free up money today to spend on other short-term programs.

And, there are just some conservatives who simply don't like the notion of borrowing. But it's time to move beyond that sort of ideology and look at the practicality of using bonding and sale leasebacks as financial tools in difficult economic times. Almost every city and school district finances its capital projects through some sort of bonding — why shouldn't the state, especially when it can help solve a crisis where the solutions either involve draconian budget cuts or an increase in taxes?

Former Governor Napolitano has suggested this approach in the past when it comes to the financing of school capital projects. But she didn't carry through with it, and she didn't propose doing it on a balanced, widespread scale so that the state could increase its reserve funds for times of need. And she didn't propose ways to scale back government costs before a crisis hit, so that the state would be better equipped to handle an economic downturn. What was a political promise became an important idea that was discarded for political expediency.

The budget debate has often been characterized as a "choice between bad options." To me, bonding to free up revenue for budget shortfalls is a better choice than gutting services — which many Arizonans simply do not want to do — or raising taxes, which could further stunt Arizona's future economic growth.

Increasing State Budget Reserves

We got here because the State's leaders have behaved like Aesop's grasshopper — during the good times, they fiddled all of the state's time and resources away. Instead of putting enough aside for the bad times, Governor Napolitano and willing Legislators kept spending ever-increasing amounts of money as if massive

economic growth were a sure thing. Sure, several legislative leaders insisted that some funds be put away for a “rainy” day, but the amount set aside was less than a month’s worth of a typical year’s operating budget. Not much to count on in bad times.

We obviously can’t start stuffing money into mattresses while we’re figuring our way out a \$3 billion budget deficit. But when the economy recovers — and it will — priority #1 should be to build a reserve fund based upon the premise of handling an economic downturn similar to the one we are facing now.

It’s simple logic to set aside enough money to cope with bad times. That’s what we’ve done in Tempe. From July 2004 to June 2008, the last “good times,” Tempe nearly doubled its general fund reserves. Now in this bad time, we are using that extra reserve to help us continue city services and avoid layoffs. So far, we are on course to trim about 10% of our total workforce without a layoff.

This reserve money is an example of “one-time” money. Once it is spent, it is gone for good. So it must be spent to achieve permanent changes in our future budget years. For example, we will use some of those reserves to encourage senior employees to retire sooner than later. That eliminates jobs we don’t need filled and tends to eliminate those positions receiving our biggest salaries, helping to reduce future years’ expenses. We also are seeing some jobs eliminated through normal attrition and, because we saw the recession coming early enough — April of 2008 — we froze our hiring at that time and haven’t filled positions as they became vacant. We then are working with our employees to reposition many into jobs we need filled and seeking to eliminate those jobs that are lower priorities to our community. This downturn is actually allowing us to “reorganize” our city government to provide more efficient and effective delivery of services.

So how should our State leaders calculate what’s needed for such a reserve? It’s not that tough to figure out. What we did in Tempe was look back to the last recession and calculate the amount of money that we originally projected the city would have and compare it to the actual results during the recession. The difference, \$28 million, was my target for the amount of extra money we needed to save to protect the city, its residents and the employees who deliver the city services, from the next recession — the one we’re now in. The state should do the same thing.

Given what our past Legislature and Governor decided was necessary spending for recurring programs, we only need to look and see how far short we’ve been. That gives us an idea about how much we need savings. At this point, it looks as though for a severe downturn like this one, this State needs something like \$2 to \$3 billion dollars over a two-year period. That’s a 20% to 30% reserve. It may sound daunting, but if revenues return to near where they were in 2007, and expenditures are locked around the levels we can expect in the 2010 budget, an economic recovery would quickly generate budget surpluses in Arizona that can be used to prepare us for the next recession.

Saving that kind of money is hard, but it can be done if leaders exercise fiscal restraint. They also must recognize the immorality associated with spending all the money “today” for current political benefits and saddling the future generations with cutting not just the “fatty” programs that are more easily expendable, but, like some of the choices our current Governor and Legislators now face, cutting into the “bones” of our State’s services.

Recognizing the difference between one-time and recurring revenues and expenses

Of course, reserve money only can be saved up during the “good times.” That means when good times return, the Legislature and Governor must restrain themselves from their great desire to satisfy every

constituent demand for spending and instead impose fiscal discipline to reserve funds until an appropriate reserve is established. That's tough to do. Are you willing to constrain yourself and your friends from demanding more State spending? Are you willing to elect representatives that stand for such fiscal responsibility?

Our leaders need to agree that, no matter what they finally end up choosing as their *recurring* spending priorities, whether it's prisons and public safety or teachers' salaries and all-day-Kindergarten, they must not spend more money than the State reasonably will collect on a recurring, annual basis into the future. No more using "one-time" fund sweeps or "delayed" payment schemes and pretending that that can be done more than once. The gimmicks need to be gone, whether proposed by a "popular" Democratic governor or supported by "bold" Republican legislators.

In the mid-2000s, as revenues grew at an unprecedented rate, the then-Governor treated the unusual growth in the State's revenues as if they would continue to grow at that rate forever. Some would like to do the same thing with the Federal Stimulus money too. These folks use this "unusual" revenue to buy stuff they may not be able to afford in the future. They then hope — and in the case of our last Governor, *counted on* — never having to face the voters to be held accountable for the spending spree.

Because of the failure to stick to sound budget principles, in the last five years, the State's general fund recurring spending went from \$6.5 billion to more than \$11 billion. The State spent the huge excess in revenue growth as "recurring" forever, and bought programs that would have annual payments due. We can't do that anymore. Worse, when the signs of trouble were spotted by early 2008, the State still increased the annual budget significantly, by approximately \$1.3 billion in non-mandated spending and used gimmicks to "balance" the budget. This was a second form of using "one-time" money as if it would recur forever.

And, these "leaders" resorted to budget gimmicks. The state "swept" money out of bank accounts that were intended for long-term investments in highways and roads, and now the Legislature proposes to do the same to funds that municipalities use to fund projects in our communities. Also, during Governor Napolitano's tenure, the state essentially held a payment to the state's schools for a few days, until the "next" fiscal year so it would be against the next year's budget. That way, the "prior" year's budget would "technically" be balanced. The next year's budget, as the former Governor perhaps hoped at the time, would be someone else's problem. Well, now it's ALL OUR problem.

Summary

It's time to stop the gimmicks and runaway spending. Solving Arizona's fiscal crisis is not something that's going to be accomplished with a year-to-year approach. Instead of focusing on accounting slight-of-hand and tunnel-vision measures, we must look at the problem with a broader frame of mind.

Yes, we must trim what state government spends, and when we achieve that, we must have the discipline not to revert to old habits when the economy recovers. But we also must focus on restructuring how we spend money, saving enough to deal with another crisis and understand the impact of our fiscal decisions on the future.

We have an opportunity in front of us right now to reverse a decade of bad fiscal habits and plan for our future responsibly. It may be the case that all we are feeling right now is the pain, but once we get past this, we'll find that our children and our future are better off for our discipline.