

## **Medicaid Expansion and Sales Tax Reform Dominate Arizona's Budget Process**

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### **Introduction**

When Governor Jan Brewer began her State of the State Address on January 14, 2013 to open the legislative session, a copy of her speech had been distributed beforehand to legislative leaders and the press. It contained no mention of Medicaid expansion, so when, midway through, she appeared to go off script and called for expanding Medicaid coverage in the state, she set the tone for a battle between pragmatists and ideological conservatives within the Republican Party that would take until June to resolve, making this the longest session since 2009, which took 171 days (Mejdrich 2012, Brewer 2013, Sanders and Sanchez 2013).

Meanwhile, outside of proposed changes to the state's complex sales tax system, which had alarmed cities and towns, the budget process was fairly docile with the question lingering all session regarding whether the governor got her primary objective of Medicaid expansion through the state legislature where leadership was opposed to the plan.

While other areas of the budget may not have been contentious, that is not to say that Arizona's budget situation is healthy. A temporary one cent sales tax expired in May 2013 costing the state nearly \$1 billion in annual revenue. The state continues to be at or near historical lows in General Fund spending as a percent of personal income, and significant tax breaks and tax expenditures designed to lure business will impact revenues eventually by half a billion dollars annually over the coming years. In addition, the state continues to carry a \$1.2 billion "rollover" whereby part of current year expenditures are paid in the following fiscal year (Joint Legislative Budget Committee 2014). So Arizona's long-term budget outlook remains precarious, particularly if there is a downturn in revenues.

### **Sluggish Economy and Arizona's Recent Budget Maneuvers**

Arizona's economy continues to be sluggish though there are signs of economic improvement. Arizona has higher unemployment than the country as a whole, finally dipping below eight percent in November 2013. The Current Population Survey shows 150,000 people have left the labor force since its peak in 2008, whereas for the country as a whole the labor force has recovered (Wells 2013a). The payroll survey shows slightly higher job growth in the state in the past year (Bureau of Labor Statistics n.d.), and the forecast is better than most states, but overall revenue growth remains limited (Joint Legislative Budget Committee 2014).

Arizona is about twice as dependent on construction as the nation as a whole, as a state that has maintained high rates of immigration (much of it illicit from Mexico and Central America), augmented by new resident migration from other parts of the United States. Immigrants have often filled construction jobs, while housing demand is driven by both factors. The 2008 housing market collapse hit Arizona particularly hard, with General Fund revenues tied to construction falling from \$1.1 billion in FY2007 to \$480 million in FY2012 (Arizona Department of Revenue 2008, 2013). Despite political posturing by state Republicans against the Obama stimulus program, its aid to the state was critical during the recession.

The state took a number of measures to increase revenue. It borrowed against future lottery proceeds, sold and leased back state buildings, swept funds outside the General Fund and put those monies into the General Fund, and engaged in accounting tricks like shifting expenditures in the final months of the fiscal year to the next fiscal year, primarily in K-12 education. This “rollover,” normally paid off by this point in an economic recovery, currently amounts to \$1.2 billion (Joint Legislative Budget Committee 2014). By Fiscal Year 2013 General Fund spending relative to state personal income had dropped to 70 percent of what it had been 20 years earlier. See Figure 1.

These measures were insufficient to sustain the state fiscally, so in January 2009, upon taking office after the resignation of her Democratic predecessor Janet Napolitano, former Republican Secretary of State Jan Brewer assumed the governorship and began pushing a policy the Republican legislature would never have considered if it came from Napolitano—a temporary three-year one-cent sales tax primarily for education.

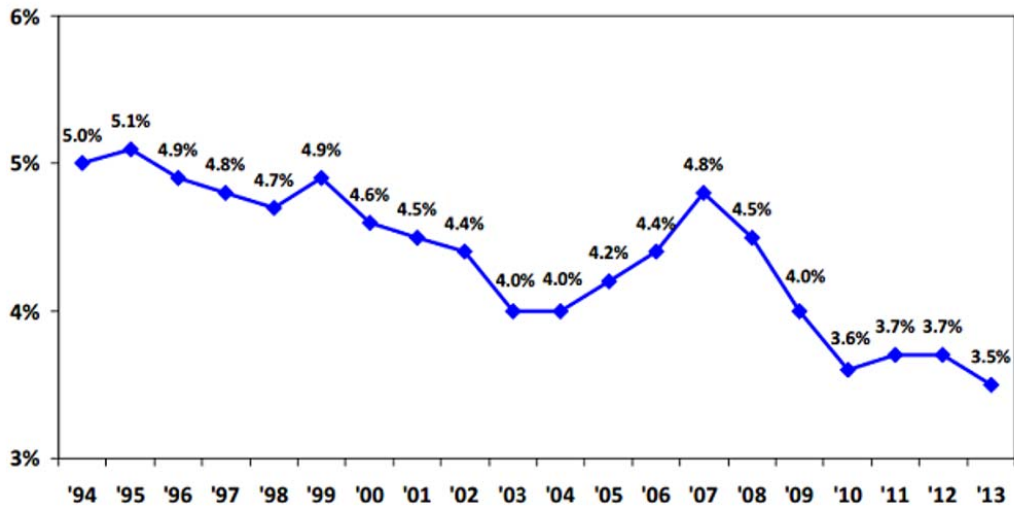
Republicans in the legislature didn’t jump at Governor Brewer’s proposal either. It took Brewer a year to get the Republican-controlled legislature to move it forward, and then they only did so as a referral to the ballot for a special election in May 2010. Although it was sold as going primarily to education, the legislature wrote it loosely enough that they could cut K-12 education with one hand and backfill it with revenue from the tax (Small 2010).

Despite widespread support from the business community and winning nearly two-thirds of the vote, the temporary sales tax put Brewer in a vulnerable position with her base as she faced the ballot herself in November 2010. Many Republican challengers emerged, and they gradually disappeared as the political fervor around the anti-immigration measure SB1070, which the governor embraced in April 2010, overwhelmed conservative antipathy to the tax proposals. Republicans rode SB1070, the tea party insurgency, and anger at the Democrats in Washington to a sweep of statewide offices and supermajorities in both the state house and senate.

The supermajorities sought to balance the budget and grow the economy in the same ideological way as they had for the last two decades through tax cuts. But cuts could not be enacted immediately and were phased in under a so-called “jobs bill.” In 2010 Governor Brewer vetoed the tax cuts as too large and phased in too quickly. A slightly adjusted version of the bill became law in 2011 with \$500 million in annual tax cuts aimed at business phased in through FY2018 (del Puerto and Beckner 2011). Given current General Fund revenues of approximately \$9 billion, the reduction represents about five percent of future annual revenues.

The state budget in 2011 and 2012 had been balanced in large part on the backs of universities. The legislature did not consider policies aimed at overhauling corrections, which have been eating up a growing share of the state budget. County attorneys continue to defend Truth in Sentencing that require inmates to serve at least 85 percent of their sentence behind bars, even though Arizona is the only state to apply it to nonviolent offenders as well as violent offenders (Wells 2012a).

**Figure 1. General Fund Spending as a Percent of State Personal Income**



Source: Joint Legislative Budget Committee

Prop. 301, a legislative referral ballot measure passed in 2000, included a 0.6 percent education sales tax and protected base K-12 funding. Along with the temporary one-cent sales tax, cuts to K-12 education were limited, though the legislature chose to take a very narrow reading of Prop. 301 and only applied the required inflation adjustment to transportation (which the state Supreme Court ruled against in September 2014 and impacted the fiscal 2015 budget), froze other parts of education funding, and zeroed out money for soft capital, which are funds dedicated for items like textbooks and computers. School building renewal and construction funds, which had become largely state functions after the 1994 *Roosevelt v. Bishop* state Supreme Court decision determined that low-income districts were disadvantaged, were for all practical purposes eliminated from the budget.

Proposition 204, a citizens' initiative passed in 2002, had expanded Medicaid coverage to 100 percent of the poverty line, a higher threshold than most other states. Revenue to fund the expansion came from the multistate tobacco settlement. However, that source of funds proved insufficient as Arizona's Medicaid rolls grew substantially to over one million people, such that more than one in five Arizonans was on Arizona's Medicaid system called AHCCCS (Arizona Health Care Cost Containment System).

Through negotiations and a waiver from the federal government, the state froze its coverage of childless adults starting on July 1, 2011, the start of the 2012 fiscal year. The legislature became the only state in the country to eliminate its State Children's Health Insurance Program (S-CHIP), called KidsCare. Then, realizing that repeal would disqualify Arizona from matching funds under the Affordable Care Act, it changed course and froze enrollment, ended coverage for parents, and moved eligible children to AHCCCS (Rau 2010).

The lion's share of budget cuts fell on universities and community colleges, an area that had no mandated coverage. And though the state constitution mandates that "tuition be kept as close to free as possible," higher education remained an area where costs have been increasingly shift-

ed to students through higher tuition. Tuition had already doubled, and university budgets were cut substantially with limited ability to recoup this via higher tuition.

To fill the funding gap, universities sought to expand the number of out of state students who are not subsidized by the state. Adjusted as a per pupil rate and for changes to the consumer price index, state support for universities has sunk to levels not seen since the late 1960s (Crow 2011). This dramatic change is seen in Figure 2.

While the recession was particularly harsh in Arizona, the fiscal impact was heightened by two decades of tax cuts, most of which occurred during economically flush years as a means to downsize or limit the size of government. Revenues are further handicapped by the legal requirement that it only takes a simple majority in the legislature to cut taxes but a two-thirds majority to increase them (due to a 1992 ballot measure passed after the last time the legislature rose taxes). Given Republican control of the legislature, a two-thirds vote to raise taxes is practically impossible, so the only way taxes have risen has been as the consequence of a majority in the legislature referring a measure to the ballot, such as the temporary one-cent sales tax.

Tax cuts since the early 1990s have reduced revenues by \$3.1 billion dollars, or about one-third of current revenue. Conservatives have consistently argued these were pro-growth measures, and the state has experienced higher growth than the national average during this time. But Arizona experienced higher growth than the national average for decades before taxes were substantially reduced, and its tax burden was close to the national average. Most of the earlier tax cuts focused on personal income, and attention to corporate taxes has only heightened in recent years (Rex 2013).

## **The 2012 Election**

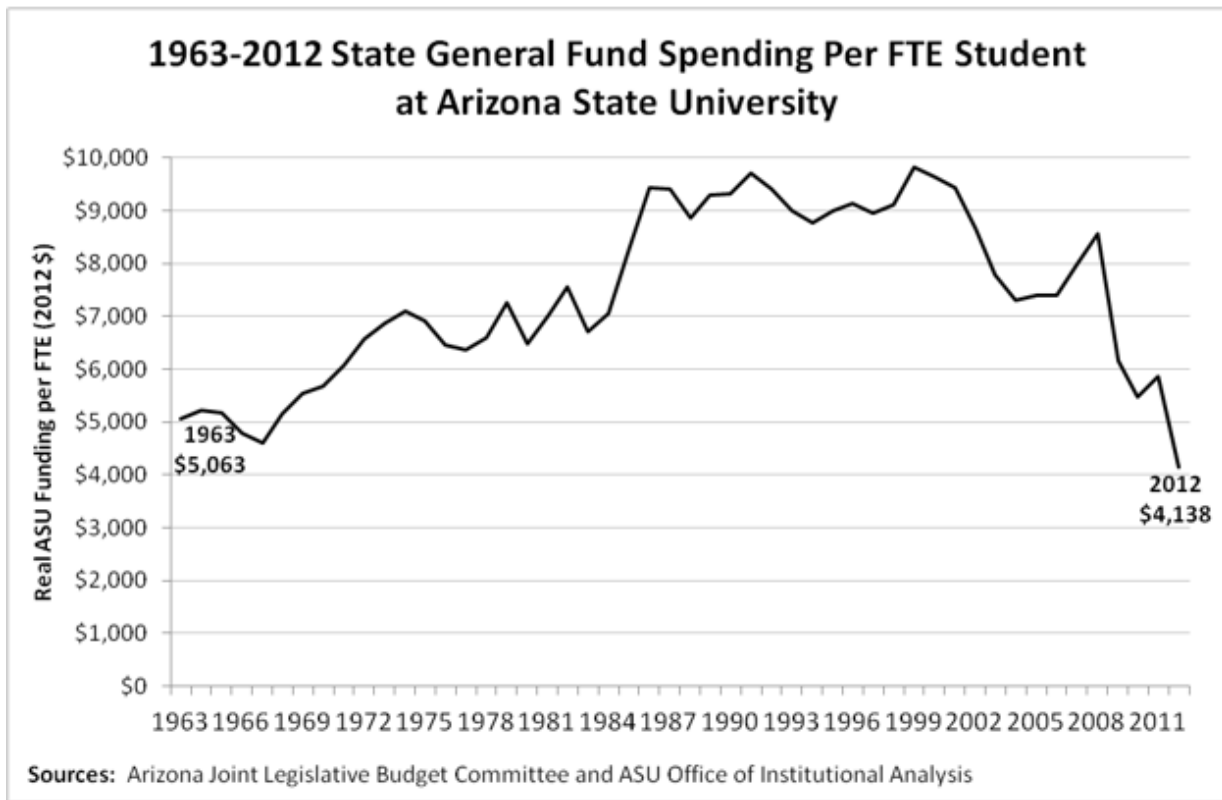
Arizona has an independent redistricting commission with Senate Republican and Democratic leaders each selecting one member and House Republican and Democratic leaders selecting one member, the four members then select from a list of independents who have applied to chair the commission. 2012 was the first election with the new maps. While congressional maps drew the ire of Republicans, both parties generally accepted the state legislative districts.

The 2012 election helped Democrats recover from their dismal 2010 election due to a more favorable mood in the electorate, a more favorable demographic turning out with the new maps to gain 13 of 30 seats in the Senate up from nine, and 24 of 40 seats in the House, up from 20. The Republican supermajorities disappeared, and two moderate Republicans can now join Democrats to block legislation in the Senate. This returned the legislature to a party balance that had been more characteristic of the body in the past decade. See Table 1.

The most conservative members of the Republican delegation were largely not impacted by redistricting, resulting in November 2012 with the more conservative libertarian Andy Biggs unseating the more pragmatic conservative Stephen Pierce for the state senate presidency by a very close vote of nine to eight. Biggs, who sponsored a bill to end the state's Medicaid program in the last legislature, was placed in a pivotal position related to Medicaid expansion.

Arizona like many states in the southwest has a growing Latino population that votes Democratic. Neighboring Nevada, New Mexico, and Colorado have already moved in a Democratic direction. Arizona State University's Morrison Institute's projections, however, suggest that Arizona Democrats won't approach parity with Republicans until about 2022 (Hart and Hedberg 2012).

**Figure 2. Declining State Investments in Arizona State University in 2012 dollars adjusted by the Consumer Price Index**



**Table 1. Party Control of Legislature, Office of Governor**

Year	House R	House D	Senate R	Senate D	Governor
2001&02	36	24	15	15	R
2003&04	39	21	17	13	D
2005&06	38	22	18	12	D
2007&08	33	27	17	13	D
2009&10	35	25	18	12	R
2011&12	40	20	21	9	R
2013&14	36	24	17	13	R

Source: Arizona Capitol Times, Political Almanac 2013.

An education initiative also appeared on the 2012 ballot. Education interests want to reverse the legislative attack on funding; an early polling suggested more than 60 percent support for keeping the temporary sales tax if it was dedicated to education. But education interests fall into

two camps: one favors school-choice, meaning charters and private schools, and the other seeks better support for traditional public schools. During the summer of 2011, representatives of both sides met outside the media spotlight to try and agree on a ballot initiative.

But the school-choice advocates pulled out, leaving traditional school supporters to go it alone. Public school advocacy groups developed an initiative that kept the one cent sales tax to be used primarily for K-12 funding and set a firm legislative floor for future funding, as well as pots of money for social services for families, reinstating KidsCare funding, scholarships for universities, and even money for construction. They counted on their broad coalition to provide the volunteers and the financial and voter support needed for passage. The measure became Prop. 204, the Quality Education and Jobs Initiative.

However, with no Democrats holding statewide offices, it lacked a champion with stature. The business community was either neutral or opposed. Having promised a temporary, not a permanent tax increase, Republican leaders lined up against it. State Treasurer Doug Ducey, a leading gubernatorial hopeful for 2014, chaired an effort to defeat it that emphasized current spending on education as wasteful and unaccountable. The governor opposed it, and anonymous outside interest groups spent millions of dollars to defeat it. The League of Cities and Towns opposed it since, by raising sales taxes, they feared it would infringe on their ability to raise their own local sales taxes.

Despite early favorable polling, it failed by a two-to-one margin, and the negative campaign against public schools also hurt attempts by many districts to pass budget overrides. State law allows districts to ask for up to a 10 percent maintenance and operations budget override paid for through local property taxes, and temporarily this has been increased to 15 percent. The overrides last five years, and then begin to phase out, so they need to be reauthorized periodically.

## **2014 Budget**

In Arizona, budget negotiations happen behind closed doors before anything is revealed publicly. The governor releases her budget in January. House and senate Republican leaders took until May to put forward a budget plan, largely due to continuing but unsuccessful negotiation with the governor's office on Medicaid expansion. Democrats were shut out of the discussions.

## **Governor's Key Initiatives**

Governor Jan Brewer's three key initiatives were Medicaid expansion, sales tax simplification, and performance-based funding for education. The details and politics of each are outlined below.

### **Medicaid Expansion**

Arizona had joined lawsuits to overturn the Affordable Care Act, but with the decision of the U.S. Supreme Court in June 2012, states had to decide whether they would seek the federal subsidies that came with Medicaid expansion.

As expected, Governor Brewer chose to allow the federal government to run exchanges in the state. The decision was consistent with her vocal opposition to the Affordable Care Act but recognized the practical reality that there was no way she could get a state-run exchange through the legislature.

The more consequential decision was what to do about Medicaid expansion. In Arizona, there were effectively three options.

1. Status Quo—maintain freeze on childless adults. The number of adults covered had dropped from 230,000 to 90,000 in a little over a year and a half and by January 2014 would likely mean all coverage for this population would end.
2. Return childless adults to 100 percent of the poverty line, based on Prop. 204. The state Supreme Court had during the budget crisis permitted the enrollment freeze. However, legal and popular pressure was growing to end the freeze as the economy recovered.
3. Expand Medicaid to 133 percent of the poverty line and qualify for added support from the federal government.

In September 2012, a relatively new think tank, the Grand Canyon Institute, released a report arguing that option 3 was the best choice, as it would create 21,000 jobs over option 1, while option 2 only created 15,000 jobs. Option 3 would actually cost the state less due to higher federal matching rates (Wells 2012b).

The only way Option 2 would cost similarly would be if the federal government gave Arizona a waiver and provided the same generous 90 percent match for childless adults and the expanded population, if Arizona only covered them to 100 percent of the poverty line, and then allowed the others to enroll in the exchange and pay two percent of their income for the premium. The governor felt she could get the legislature to accept this if she got the waiver, and those in the health care community indicate her office pressured them to at least stay mum on option 3 while the waiver was sought.

The Grand Canyon Institute considered such a waiver unlikely as the premium leads to fewer people choosing to enroll, and in December 2012, Health and Human Services Secretary Kathleen Sebelius rejected the waiver request.

That essentially made option 2 fiscally unviable.

What would the governor do? When Governor Brewer had favorable things to say about New Mexico Governor Susana Martinez's decision to expand Medicaid, it turned into even bigger news when she went off the script given to the media and legislative leaders before her State of the State Address on January 14, 2013, and publicly called for Medicaid expansion—though the campaign called it Medicaid restoration, emphasizing its similarity to existing law, i.e. option 2.

With a projected price tag in fiscal year 2014 of \$27 million rising to \$154 million in 2015, the governor carefully put forward a proposal that made expansion contingent on the federal government covering at least 80 percent of the cost (90 percent is what the Affordable Care Act called for), and that the money from Arizona would come from an assessment on hospital revenues—which given the matching rate from the federal government, hospitals were glad to do (Office of Governor Jan Brewer 2013).

The governor organized the business community and hospitals as part of a public relations campaign to advocate on its behalf similar in many respects to what was done when the temporary sales tax passed.

A bill for it dropped in mid-March, but with both House Speaker Andy Tobin and Senate President Andy Biggs opposed, the only way forward was through some connection with the budget, but both vowed to exclude it from the budget. The governor returned fire, for inaction, and began vetoing bills, telling Republican leaders to work on her priorities or they may not get their legislative priorities signed into law (Pitzl 2013a).

## **Sales Tax Reform**

The governor has made it a priority to simplify the state's transaction privilege tax system. Arizona was one of only four states that required compliance for business at state and local levels, and the tax base at the local level was not consistent across localities. In order for the state to be eligible for possible retail sales and use taxes if Congress passes enabling legislation (The Marketplace Fairness Act), the system needs to have one entry point for compliance, and the tax base needs to be made uniform—the state can assess a zero tax on items like food, but localities need to agree on what constitutes taxable food.

The governor put together a taskforce after the 2012 legislative session chaired by state Treasurer Doug Ducey. It recommended expected simplifications, but also pushed for a change in contracting taxes (i.e., construction). Under the existing law, localities could assess a local tax on the value of a contract (or a new house) and 65 percent of it is deemed taxable. Some localities charge higher local rates on construction than for retail, but recent legislation has required that those communities rebate the excess portion against impact fees.

The proposed change would make it a point of sale tax on materials paid by contractors, which will do two things. One, it would lower the state portion of the tax substantially, as materials are expected to be 37 to 41 percent of costs—far less than 65 percent. But compliance would rise to close to 100 percent from somewhere between 70 and 80 percent. But as 65 percent of 70 percent is greater than 41 percent, it was a net revenue loser. In addition, due to the state shared revenue formula, whereas 20 percent of the old amount was shared with municipalities, under the new reform 40 percent would be shared.

Two studies in March 2013 estimated possible net General Fund losses of between \$125 to \$140 million. Many municipalities expected the loss of their local sales tax on contracting would more than wipe out any possible revenue gain from state shared revenues (Transaction Privilege Tax Simplification Task Force 2012, (Wells 2013b, Olafsson 2013, Fischer 2013).

Mayors from a number of cities including Phoenix held a press conference before a hearing in the senate finance committee on March 20, 2013 calling for a study on revenue impacts from the contracting provision before moving forward, which could delay that portion of the bill by a year. There is no hard data on where construction materials are currently sourced, and cities wanted verification of the portion of contracts for materials, so they have greater revenue certainty before moving forward with the change to contracting (League of Arizona Cities and Towns 2013).

## **School Funding**

The governor's third fiscal initiative related to performance-based funding for schools. She created the Arizona Ready Commission to look into changing the state's education funding formula, chaired by former Intel CEO Craig Barrett.

Gov. Brewer's performance-based funding proposal took \$18 million of existing school funding and added 36 million of new money in its initial year. Over the next five years the \$18 million would gradually expand to five percent of school funding formulas. Independent research from David Garcia at the ASU School of Education found that if the Arizona Ready Commission funding formula were implemented, the likely beneficiaries would be more-well-off districts, with lower-income schools suffering (Garcia and Aportela 2013). Hence, groups like the Arizona Education Association opposed the initiative (Arizona Education Association 2013). The bill SB1444 cleared Senate committees and stalled.

The governor's proposed budget had \$40 million to aid with the adoption of Common Core, which will require students to take online tests that are likely to be more expensive to administer than the current AIMS tests. Costs aren't known but the state's database management system is antiquated, schools would need sufficient numbers of computers with Internet access, and school districts are looking for tests to measure progress that are reliable benchmarks with the PARCC assessments. Altogether the costs are likely to exceed \$40 million.

Conservatives in the legislature, hostile to Common Core, were not eager to embrace the funding. A formality bill to eliminate the AIMS test for graduation in 2018 since it will be replaced by the PARCCC assessments ran into a buzz saw of conservative opponents who see Common Core as a federal takeover of education (Leu and Creno 2013).

An impending lawsuit over Proposition 301's inflation formula, which the legislature had applied only to transportation, not base-level funding, was moving to the State Supreme Court, and if lost was going to require retroactive funding of \$250 to \$300 million. Conservatives were skittish of any new education funding outside inflation adjustments (Pitzl 2013b).

### **The Medicaid Budget Drama Conclusion and Fiscal 2014 Budget**

As positions solidified, it became increasingly clear that a budget with Medicaid expansion could not be passed with just Republican votes, as had usually been the case. Already State Representative Heather Carter, who had agreed to sponsor the governor's Medicaid expansion bill in the house, had attracted a primary challenge (Yellow Sheet Reports 2013).

The standoff moved into May when Senate President Andy Biggs moved the budget bill to the senate floor without Medicaid expansion. His alternative was for the state to continue its freeze on noncustodial adults enrolling in Medicaid even though that meant no federal support for that population. The price tag would be \$140 million for fiscal year 2014 and approximately an extra \$1 billion in state spending through fiscal year 2017 (Wells 2013c). So Biggs, a proponent of smaller government, was ironically proposing a more expensive option for the state, just so the state would not participate in the ACA Medicaid system.

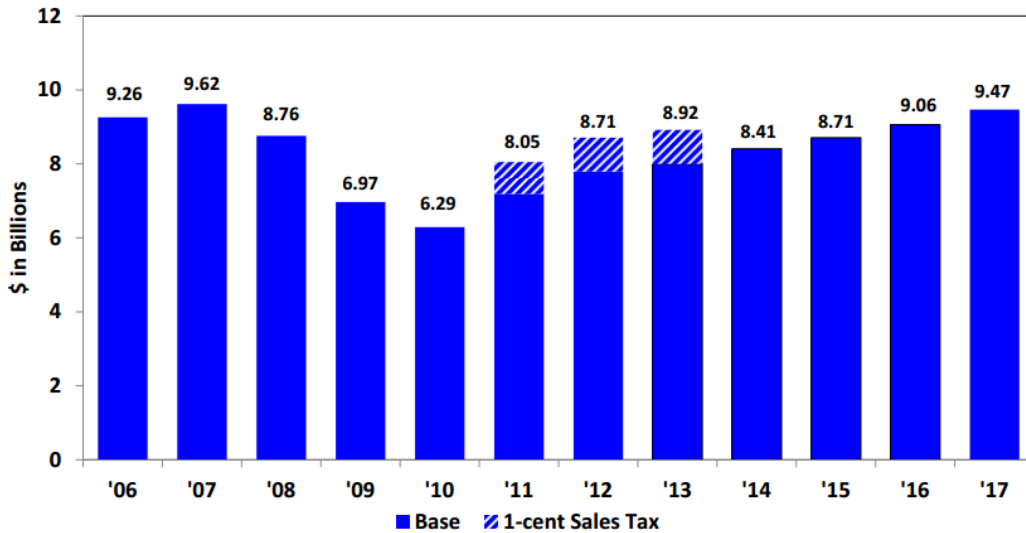
During floor debate Senate Majority Leader John McComish broke ranks and offered the governor's plan for Medicaid expansion with the hospital assessment as an amendment. A coalition of six renegade Republicans joining the 13 Democrats passed it and were able to hold off numerous amendments to make the budget untenable as it moved to the house. The coalition added \$34 million in education (K-12 and universities) and child welfare spending (Pitzl and Reinhart 2013).

The writing was on the wall for a similar maneuver in the house. Speaker Tobin resisted and threatened to start the budget from scratch. It took an entire month, but, ultimately, as in the senate, Speaker Tobin offered the budget without Medicaid expansion. In the house Medicaid expansion was added as an amendment and seven Republicans joined the 26 Democrats in passing it (Reinhart 2013).

Effectively, the Republicans who resisted Medicaid expansion were able to have it passed without their votes. Consequently, Democrats who normally are irrelevant in the budget process, provided the critical votes to assure passage of the amended budget.

The loss of the temporary sales tax revenues meant General Fund revenues dipped from the prior fiscal year and were forecast through FY2017 to remain below FY 2007 levels in nominal (not constant) dollars. Consequently the \$8.8 billion budget had to draw on the budget stabiliza-

**Figure 3. Nominal General Fund Revenues through Fiscal Year 2013, Projected for Fiscal Years 2014–2017.**



Excludes balance forward and other one-time revenues. Includes tax law changes and Urban Revenue Sharing.

Source: Joint Legislative Budget Committee

tion fund for part of its funding, a less than ideal situation during a time of economic recovery. See Figure 3.

The governor’s school performance initiative and funding for Common Core were left out of the budget. Anticipating a possible court loss on inflation funding for K-12 education, the legislature provided \$82 million instead to fully fund Prop. 301’s inflation formula for Fiscal Year 2014. They had not done so in Fiscal Years 2011–2013, and that premonition became true with a unanimous state Supreme Court decision in September 2013.

On the construction piece of sales tax reform, a compromise that was essentially revenue neutral was finally voted on after the budget passed. It limited the point of sale tax to home repair and improvements. New construction would continue under the old system. This significantly decreased the revenues lost from the change.

When combined with a new unrelated requirement for nonresidents to pay sales tax on items they bought in state but planned to ship out of state, the Joint Budget Legislative Committee forecast a modest revenue gain overall (Joint Legislative Budget Committee 2013). Audits were to be better coordinated so cities could participate and originate audits, but they’d all be done through the state—so technically all audits would be considered state audits (del Puerto 2013). With passage, the state was in compliance with the requirements of the Marketplace Fairness Act in Congress.

## Conclusion

Governor Jan Brewer once again was able to get Medicaid expansion, her top legislative priority, enacted. As with the temporary sales tax initiative in 2010, it took Democratic support to make it happen. Unlike that effort, this time she could not get a majority of her own party to back it. The drama illustrates the sharp divide between the more ideological conservatives and more pragmatic members of the Republican caucus. Pragmatic members appear to pick their battles as ideological conservatives remain the most powerful caucus element.

Unlike past years, renegade Republicans were not punished. No members lost chair or leadership positions by voting for Medicaid expansion, as some anticipated might happen. McComish remained majority leader in the Senate, and in the House Representative Bob Robson retained his chair on the influential rules committee, which can prevent bills passed by other committees from coming to the house floor.

However, primary challenges are anticipated. McComish, for instance, drew a primary challenge from a former state chair of the Republican Party and decided to not seek re-election. The 2014 election cycle may render a final verdict on the political consequences of defying the conservative base of the party.

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