




MEMORANDUM

Date: January 5, 2010

To: The Honorable Ray Carroll, Member
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator 

Re: **Your Memorandum of December 29, 2009**

I received your response to my December 28, 2009 memorandum addressed to you and the Board. As you know, this was in response to your memorandum of November 24, 2009. Below are my responses to your December 29, 2009 memorandum.

1. General Fund and Certificates of Participation. It is common practice to aggregate the payment of Certificates of Participation (COP) debt instruments in the General Fund since their repayment is a conglomeration of a number of funds as indicated in my memorandum of December 28, 2009. Our finance staff currently tracks the repayment of COP debt service and separately identifies repayment from transportation impact fees or sewer connection fees. The methodology of repaying through the General Fund is simply aggregate accounting.

The second part of your question, as I understand it, deals with paying off the COP and the Constitution. There are no constitutional prohibitions with regard to paying off COP through the General Fund. The point with regard to the Constitutional expenditure limitation is that if spent without issuing short-term debt such as COP, the expenditure of these impact fee and sewer connection fee revenues, which are not tax related, do – because of a quirk in the construction of the constitutional expenditure limitation – count against the County's expenditure limitation. If the funds are used to pay off COP debt over several fiscal years, then they do not. This is exactly how we are spending impact fees and sewer connection fees so that they do not count against our expenditure limitation. As you know, constitutional expenditure limitations were designed to limit property taxes. Transportation impact fees and sewer connection fees are not property taxes; therefore, these fees should have been exempted from the constitutional property tax expenditure limitation. Unfortunately, the framers of the expenditure limitation measure could not have addressed County sewer connection fees, which were instituted after the 1979 election or about impact fees, which did not exist before 1990. The

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expenditure limitation measure failed to acknowledge the finer points of governmental accounting.

2. Total County Debt. As I indicated in my memorandum of November 13, 2009, the period for which the debt of all counties was available was for the fiscal year ended June 30, 2008. That was the debt of \$757 million listed in my memorandum. The number used in your memorandum is again mixing authorized debt and issued debt. Any amount of debt can be authorized; it only becomes an actual repayable debt when issued, i.e., bond proceeds taken to market, cash transferred in exchange for the bonds, cash used for public projects, or future taxes raised to repay the bond instruments. Authorized bonds to be sold in the future must meet a number of tests that may have been imposed by the Board in the planned debt financial management plan of the County. In our case, it is the limitation of the secondary property tax rate. In addition, there are some purposes for which bonds have been authorized but not yet loaned or expended, and it is potentially likely they will not be. For example, in 1997, the County received voter authorization to issue up to \$12.5 million in bonds for landfill environmental remediation. To date, only \$6.1 million of those bonds have been sold. It is unlikely any of the unsold authorization will be needed for the purpose specified in the bond issue unless/until a landfill is closed many years from now.

With regard to your last comment in Section 2, the process for developing, delivering and completing bond projects as specified in the County Code, Section 3.06.010 through 3.06.090. It is this process that has been in place and effectively utilized for years. The Bond Advisory Committee (BAC) is the primary body responsible for bond administration and oversight. They effectively perform this duty several times a year. All progress is fully documented in reports given to both the BAC, as well as the Board and updated periodically in ordinance form as specified in County Code.

3. Growth Paying for Itself. There continues to be some confusion between authorization and debt issuance. Bonds that actually sold at market, which the Board does approximately once a year, become debt obligations the County must repay with secondary property taxes. Eighty percent of the aggregate debt of bonds once issued is paid off within 10 years, and all debt is paid within 15 years; hence the average 12-year bond life once issued. Twenty-eight years divided by 15 equals 1.9, approximately half of a single generation; hence our obligation, not that of our children.

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4. Adopt a Pay-as-you-go System. The Bond Advisory Committee will be the body that makes a recommendation to the Board as to whether to hold a bond election in November 2010. It is then the Board's decision as to whether such will be held.

The constitutional limitations are what they are: they are exactly as stated in my memorandum.

The Bond Advisory Committee has requested the Board place on a future agenda discussion of the timing of a bond election, whether it should occur in November 2010 or later. I assume such will be scheduled for early February.

Finally, a 2008 study from Arizona State University's Business School deals with the issue of debt financing and future generations. The author found that Arizona public investments in infrastructure have not kept up with the needs of a rapidly growing population. But more specifically, the author wrote that debt financing is appropriate for public projects that provide multiyear and many times multigenerational benefits, as opposed to pay-as-you-go financing that places the burden on the current population over a short time period. For example, many of the facilities we build today will still be serving future generations. Similarly, they will likely be serving new residents who move here years from now. The study is attached for your review.

Please let me know if you require further information regarding this matter.

CHH/mjk

Attachments

c: The Honorable Chairman and Members, Pima County Board of Supervisors
Chairman and Members, Pima County Bond Advisory Committee




PIMA COUNTY BOARD OF SUPERVISORS

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RAY CARROLL
COUNTY SUPERVISOR
DISTRICT 4

Date: December 29, 2009

From: 
Ray Carroll
District 4

To: C. H. Huckelberry, County Administrator

Re: Your December 28, 2009 Memo on County Debt

I have received your December 28, 2009 memo in response to the Bond Advisory Committee's request that you address issues concerning Pima County Bond Indebtedness and its implications for a 2010 Bond Election. I appreciate the committee members request for a response, and fully support their suggestion that the Board of Supervisors places the item on a Board agenda to discuss these issues openly. I hope that you or Chairman Elias will do so as soon as possible. As you know, I have been asking many of these questions since last October.

You listed five items, each of which has my questions below:

1. Use of General Fund as Pass-through of Debt Service Payments for Certificates of Participation (COP).

Why does Pima County transfer funds (wastewater connection fees, development impact fees, non-General Fund department rents) into the General Fund before using them to pay off Certificates of Participation?

In Item 4, sub-Item 4 you state that *"temporary COP financing was to permit the use of impact and connection fees for construction rather than using bonds. The use of impact and connection fees is limited by the Constitutional expenditure limitation."*

If these funds cannot be spent to pay off COPs without violating the Constitution, is it appropriate to transfer these funds to the General Fund and then use them to pay off COPs?

2. Total County Debt.

I appreciate your acknowledgement of my point about trying to determine the TOTAL Pima County debt, including principal plus interest. Your currently listed **\$1,076,974,325**

debt figure is substantially more than your original “reported indebtedness” of only **\$757 million**.

As my memo indicated, the figures you provided in your memo (11-13-09) lists a total debt of **\$1,682,398,235** (including Long Term Debt, unused G.O. Bonds, 1997 HURF Bonds, Sewer Revenue Bonds, and COP bonds).

In paragraph 5 of your response you seem to avoid a critical point, suggesting that we should disregard “*potential future debt*” because it represents bonds that have yet been sold. However, they have been AUTHORIZED to be sold by the voters, including both the principal and interest on those unsold bonds.

As indicated in my November 24, 2009 communication (page 3) I stated:

“Although bonds authorized by the voters but not yet sold will not technically become ‘debt’ until the bonds are sold, these bonds must be sold in order for the voter – authorized projects to be completed. Therefore, these bonds must be sold and will constitute a major portion of Pima County’s debt in the FY08-09 to FY 2025-26 time frame covered by the Administrator’s report.”

Therefore, the only way that the **\$1,682,398,235** debt could not be real is if Pima County has no intention of delivering the bond projects that were promised.

Have our promised projections for delivering and fully completing all bond projects been changed, reduced, or eliminated?

3. Growth Paying for Itself.

You dispute my contention that “the County debt will be the responsibility of our children” to pay, claiming that my statement is “not true.”

Since there are bond projects currently scheduled to be constructed “beyond 2023,” the bonds for their construction will be sold at the time of construction.

The 15-year bonds you reference will not be paid off at least until 2038.

According to biblical (and most people’s) definition, twenty-eight years in the future is the next generation.

4. Adopt Pay-as-you-Go System.

As I clearly indicated in my memo, I suggested that “Pay-as-you-go” was “*one solution to Long Term Debt*” to be used “*until some of our debt is paid down.*” I never suggested that future bonds should never be considered.

As you know, I have always supported voter approved bonds elections in the past. My opposition has always been to non-voter approved Certificates of Participation which bypasses the voters, as well as ignoring any consideration by the Bond Advisory Committee members and their recommendations. As you know, tens of millions of dollars in COP debt has been issued based on your recommendations alone and with a vote of the Board majority.

With the current economic slump, and the fact that for every one dollar worth of construction, it costs the taxpayer approximately \$1.30 to pay back bonds, I seriously question the timing of a 2010 Bond Election at this time.

Finally, you state that the Constitutional limitations on expenditures for Fiscal Year 2009/10 are limited to \$506 million annually, but "*exempts debt payments from the limitation in order for jurisdictions to borrow funds to construct capital projects.*"

To be exempt from the Constitutional expenditure limitation, does not the debt first have to be voter-approved? Or is there no limit on this exemption/loophole?

I appreciate your response, and am especially thankful to the Bond Advisory Committee for their attention to my concerns, their request for answers, and their suggested placement on the Board of Supervisor's agenda of these issues at the earliest possible availability.

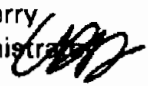
c: Board of Supervisors
Bond Advisory Committee



MEMORANDUM

Date: December 28, 2009

To: The Honorable Chairman and Members
Pima County Board of Supervisors

From: C.H. Huckelberry
County Administrator 

Re: **County Bonded Indebtedness and Supervisor Carroll's November 24, 2009 Memorandum**

On November 24, 2009, Supervisor Carroll sent a memorandum to the Board of Supervisors regarding my report of November 13, 2009 on this subject (Attachment A). Supervisor Carroll also sent the report to the members of the Bond Advisory Committee (BAC). The BAC asked that I address the issues raised by Supervisor Carroll. This memorandum responds to those issues.

Prior to responding to each area of concern outlined Supervisor Carroll's memorandum, it is appropriate to indicate that County Administration is not promoting a bond election next year. What is being considered by the BAC is whether to hold a bond election in 2010 and for any future bond election, what projects would be recommended for inclusion in a referral to the voters. At the December 18, 2009 BAC, I was asked directly what my recommendation would be with regard to a bond election in November 2010. I indicated that if the current economic conditions continue or worsen, I would not recommend that a bond election be held in 2010. It was a simple answer to a direct question from the BAC Chair. This is the same answer I would repeat if asked again. I believe it is perfectly appropriate to be prepared and to plan carefully, which is the action the BAC is taking. The BAC also asked that the Board of Supervisors place an item on a future Board agenda to obtain the thoughts of the Board with regard to a future bond election. Since the legislature has restricted all future elections to a November date, the earliest date for a bond election is November 2010; however, 2011 and 2012 are also possible.

As I stated in my November 13, 2009 report to you, I continue to believe that the County's debt is well managed and aggressively monitored. Our debt is short-term – paid off entirely within 15 years and 80 percent within ten years. It is used for vital public improvements. Today, the cost of these public improvements is lower than it has been in some time, and the cost of borrowing capital is the lowest it has been in the last 30 years. These are simple, verifiable facts; they are neither conjecture nor speculation.

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In response to the points raised in Supervisor Carroll's memorandum, I offer the following:

1. Use of General Fund as Pass-through of Debt Service Payments for Certificates of Participation (COP). Mr. Carroll's memorandum questions the use of General Fund monies to pay for COP debt. The repayment of COP debt is made from multiple funding sources. A portion does come from the General Fund (for part of the payment of the debt for the Bank of America Building and for the portion of the Stadium debt that is not covered by Stadium revenue). However, the majority of the debt payments come from funds that are transferred into the General Fund from the other funding sources and then transferred from the General Fund into the Debt Service Fund to pay debt service.

The \$94.7 million of debt service for COP shown on Page 7 of my November 13, 2009 memorandum consists of approximately \$40 million of remaining debt service (both principal and interest) for the Justice Building (Bank of America Building) paid over a 14-year period and \$54 million for temporary financing, primarily for wastewater projects and transportation projects paid over a three-year period. Although debt service for COP is budgeted in the General Fund, General Fund monies do not pay for all of this debt. The \$54 million of temporary financing is being paid from wastewater connection fees and transportation impact fees, which will be transferred from those funds into the General Fund. The \$40 million for the Justice Building and Jackson Training Center will be paid from a combination of sources, including rents from private tenants in the building, rents from non-General Fund departments, and from the General Fund for use of the building by General Fund departments, including the Assessor, the Information Technology Department, the Finance and Risk Management Department, and Indigent Defense. As can be seen, the statement regarding taxpayers is essentially correct. Most COP are repaid from user fees, growth-related fees, and revenues from rents and payments required by contract from private parties.

General Obligation Bonds, on the other hand, are approved by voters and paid with secondary taxes budgeted in the Debt Service Fund.

2. Total County Debt. Mr. Carroll's memorandum discusses the total debt for Pima County. For the fiscal year ending June 30, 2009, Pima County provided two reports to the Arizona Department of Revenue (ADOR) as required by statute: (1) Pima County reported \$752 million of bonded debt and Water Infrastructure and Financing Authority (WIFA) loans in the report titled, "Report of Indebtedness Made to the Arizona Department of Revenue;" (2) Pima County reported \$95.8 million of non-bond debt in the report titled, "Lease Purchase/Third-Party Contracts Report Made to the Arizona Department of Revenue." This second ADOR report on leases includes the \$84.4 million of COP issued in 2008 and 2009, of which \$40 million of principal had already been retired at the time of the report.

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Approximately \$50 million remaining COP debt (\$95.8 million less the \$44.4 million of remaining for the 2008 and 2009 COP) represents the outstanding obligation for the Stadium (\$23 million) and the Justice Building (\$27 million). In total, Pima County reported total indebtedness of \$848 million as of June 30, 2009. Both ADOR reports are attached (Attachments B and C, respectively).

Highway User Revenue Fund (HURF) Debt – the Missing \$40 million. In the Report of Indebtedness (Column 8, Lines 23 through 27), Pima County reported the original principal amount of \$187.2 million for the five HURF bond issues that remain outstanding as of June 30, 2009. Pima County has, however, issued a total of \$227.2 million of HURF bonds. The difference of \$40 million is the original principal amount of the 1998 issue that was paid in full on July 1, 2008 and was not outstanding at June 30, 2009. The ADOR report lists only the original amount of outstanding bonds, not any prior debt that has been fully paid. The statement in October that there was \$122.8 million of authorized but unissued HURF debt was accurate. Subsequently, on November 17, 2009, Pima County issued an additional \$23.3 million of HURF debt, representing \$15 million of new HURF debt and the refunding of \$8.3 million of prior debt.

Differences Between the June 2008 ADOR Report and the January 2009 Pima County Long Term-Debt Manual. Mr. Carroll's memorandum compares the ADOR report to the County's internal debt manual and notes several differences. These two documents are not intended to have the same information. They present two different things at two different dates. The \$757 million in the ADOR report consists of the outstanding principal amounts as of June 30, 2008 but shows no future interest payments. The \$1,076,974,325 in the Long Term Debt Manual represents both principal at January 31, 2009 (seven months later) and all anticipated interest to be paid over the next 15 years, through 2026, assuming none of the debt is refunded at lower interest rates.

Statements About Total Debt. Supervisor Carroll's statements summarizing Pima County's debt to be \$2.4 billion and total debt, including the City's debt, as \$3.5 billion, mixes existing debt with potential future debt and erroneously includes 15 years of interest payments on the County's debt. In Fiscal Year 2009, Pima County paid down \$104 million of its outstanding debt. For the next several years, Pima County expects to pay at least \$65 million of principal annually. Any analysis of future debt must consider the pay-down of existing debt.

3. Growth Paying for Itself. Mr. Carroll's memorandum discusses the public cost of development. Although I cannot address the issue of whether impact and connection fees are sufficient to cover the cost of growth, the statement that the County's debt will be the responsibility of our children is not true, except for jurisdictions that issue debt for long

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periods, such as 40 or 50 years. Pima County issues almost all debt for 15 years or less and pays for approximately 80 percent of the debt within 10 years. We do not borrow against future generations. New residents who move here during the debt retirement period do partially help pay for the cost of facilities that serve them.

4. Adopt a Pay-as-You-Go System. Under the Constitutional limitations on expenditures, a pay-as-you-go system cannot work in Arizona. Under our Constitution, Pima County expenditures for Fiscal Year 2009/10 are limited to \$506 million annually from local revenues. Local revenues includes primary property taxes, sewer revenue fees, impact fees, development fees and any fine, fee or charge adopted by the Board of Supervisors. The Constitution exempts debt payments from the limitations in order for jurisdictions to borrow funds to construct capital projects. If the funds are not borrowed funds, the expenditures are included in the expenditure limitation. In order to use a pay-as-you-go approach, Pima County would have to eliminate all capital projects or cut its operating budgets of departments funded with General Fund monies (e.g., Sheriff, County Attorney, Indigent Defense, Treasurer, Assessor, Recorder, Superior Courts, Health Department, Parks, etc.), as well as the operating budgets of the Regional Wastewater Reclamation Department, Development Services Department and the Transportation Department, and payments to outside agencies by the amount of the County's capital program (currently budgeted at \$200 million). This would require cuts of approximately 30 percent of these operating budgets.

In Attachment 1 to his memorandum, Supervisor Carroll raises several other questions:

1. The Lease Purchase/Third-Party Contracts Report made to the ADOR discussed above is attached.
2. As discussed above, COP are a form of leased financing and are reported on a different report to ADOR. This report is attached.
3. The \$40 million difference in HURF funding is, as discussed above, the amount of debt borrowed in 1998 and paid in full in 2008.
4. The purpose of the temporary COP financing was to permit the use of impact and connection fees for construction rather than using bonds. The use of impact and connection fees is limited by the Constitutional expenditure limitation.

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5. The Comprehensive Financial Reports (CAFRs) for the past ten fiscal years, Fiscal Years 1997/98 through 2007/08, are posted in a searchable format on the Finance web page at: <http://www.pima.gov/finance/HTML/Reports.html>.

Each CAFR is comprised of approximately 160 pages, and a hard copy is provided to each Supervisor when issued. If necessary, Finance can print the last five CAFRs for those supervisors who require another hard copy. The FY 2008/09 CAFR will be finalized the week of December 28, 2009 and will be provided to each member of the Board of Supervisors. The Long Term Debt Manual is completed and updated each January and can be provided to the Board of Supervisors at that time.

CHH/mjk

Attachments

- c: Chair and Members, Pima County Bond Advisory Committee
Tom Burke, Director, Finance and Risk Management Department

**PUBLIC INVESTMENT USING DEBT
FINANCING AND THE EFFECT ON
ECONOMIC ACTIVITY: PERSPECTIVES FOR
THE STATE OF ARIZONA**

A Report from the Office of the University Economist

January 2008

Dennis Hoffman, Ph.D.
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This brief report provides conceptual perspectives on public investment using debt financing. Empirical evidence of the relationship between public investment and economic activity is provided, showing that moderate levels of debt do not impair economic growth and may provide a stimulus to growth.

Arizona's public debt currently is low relative to national standards. Related to this low debt, public investment in infrastructure has fallen behind the state's population and economic growth over the last 15 years. Because of low interest rates and a construction slump that will reduce construction costs, current conditions are ideal for public investment using debt financing.

BACKGROUND

Financing capital projects such as school construction using debt financing is a capital-budgeting practice akin to the investment decisions made in the private sector on a daily basis. Essentially, private-sector firms compare the discounted net revenues that accrue from private investment decisions with the cost of the financial capital required to fund any given project.

Failure to employ the capital markets in this fashion would leave the private sector with a suboptimal number of completed projects and an underutilization of financial resources. Indeed, economies with poorly functioning capital markets languish because it is not possible to fund major capital items without long-term financing. In contrast, advanced economies with access to efficient, freely functioning capital markets flourish by using financing for capital expenditures. This is one of the key distinctions between first- and third-world economies.

The basic principle of efficient capital budgeting applies to the decision to put public infrastructure in place, be it in the form of public highways, prisons, elementary and secondary schools, water treatment facilities, or university buildings, even though these investments do not yield net revenues from physical plants or production lines. To minimize costs and maximize public benefit, policymakers should make building decisions that consider the advantages of access to capital markets. A newly constructed school can yield direct benefits (analogous to net revenues in the private sector) to students — many of whom have not yet moved to Arizona or even been born — over the life of the school and indirect benefits to society that span generations. Similarly, roads deliver benefits over their lifetime of use and these benefits accrue to citizens who have yet to move to Arizona and to future generations. While it is difficult to translate the benefits of public investments into dollars, such benefits certainly exist or new schools or new roads should not be built at all.

Debt financing is an appropriate mechanism for public capital investments because the benefits of the new physical capital extend far beyond the year in which the facility is constructed. For example, financing a school over its lifetime is an efficient way of matching benefits to costs in the same manner that private-sector firms match future net revenues to continuing debt service. Moreover, the students who benefit from new

schools, drivers who use the new roads, and families who move to new areas of development include future taxpayers. Failure to utilize debt financing is unfair to current taxpayers — especially the elderly who may not live to realize the benefits — and inefficient since a suboptimal amount of public infrastructure is put in place to serve current and future needs.

FEDERAL GOVERNMENT DEBT PERSPECTIVES

While sound reasoning supports the notion of debt finance, when the topic of debt arises many people think of the obligations of the federal government. Images of mounting debt, foreign ownership, unfairly saddling future generations, etc. come to mind. The federal debt in nominal dollars is shown in Figure 1.

An analysis of federal debt in nominal dollars provides an incomplete picture for a host of reasons: primarily, it fails to account for growth in the nation's population and economy, and it does not consider inflation. In Figure 2, federal debt outstanding relative to the size of the economy, as measured by gross domestic product (GDP), is displayed.

Figure 2 provides a very different perspective on the size of federal debt. The major acceleration of debt occurred in providing financing for the Second World War. The large public expenditures during the war years were the likely catalyst for lifting the nation out of the doldrums of the Great Depression. Few would disagree with the argument that the benefits of taking on this debt at this time exceeded costs. The benefits of financing accrued immediately and, following the postwar adjustment for conversions from wartime to peacetime manufacturing, set the stage for economic growth that has exhibited a steep trajectory (see Figure 3).

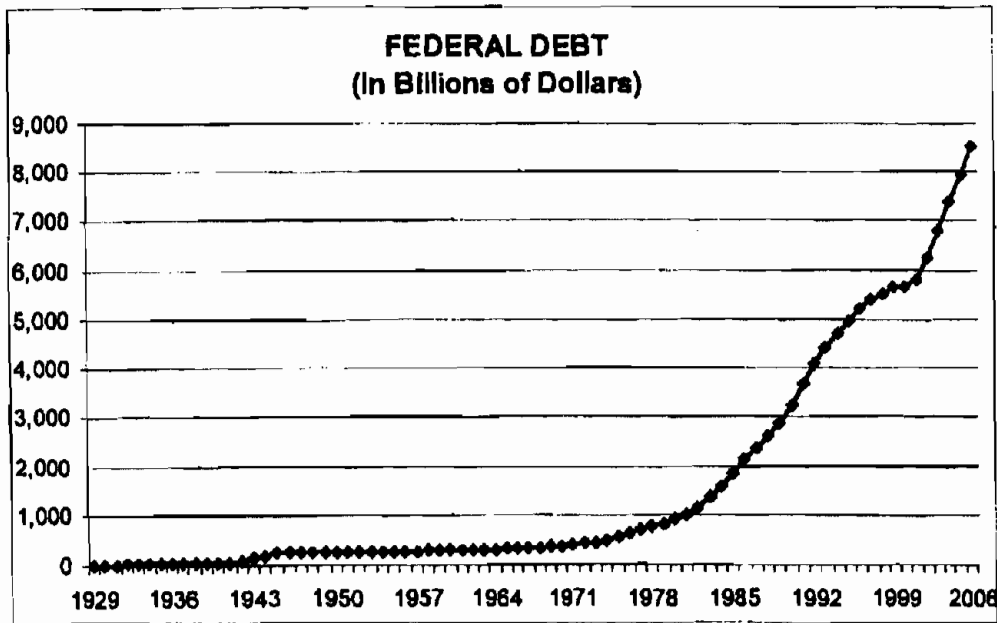
Moreover, taking on debt during a time when the investment was warranted did not create an irreversible thirst for acquiring more debt. Indeed, federal debt as a share of GDP declined steadily from 1946 through 1974 and did not begin to rise until 1982.

Federal debt as a share of GDP rose substantially from 1982 through 1993. This rise has a number of explanations. For example, tax cuts in the early 1980s were not offset with expenditure reductions, and military spending increased. However, the fiscal policies of the 1980s may have set the stage for business investments that stimulated robust economic growth in the 1980s and 1990s.

The data illustrated in Figures 1 through 3 suggest that there is no discernible correlation between acceleration in the federal debt burdens and negative economic performance. Indeed, it appears that strategic public-sector investments might stimulate future growth. However, the decision to use debt financing should incorporate the consideration of other factors.

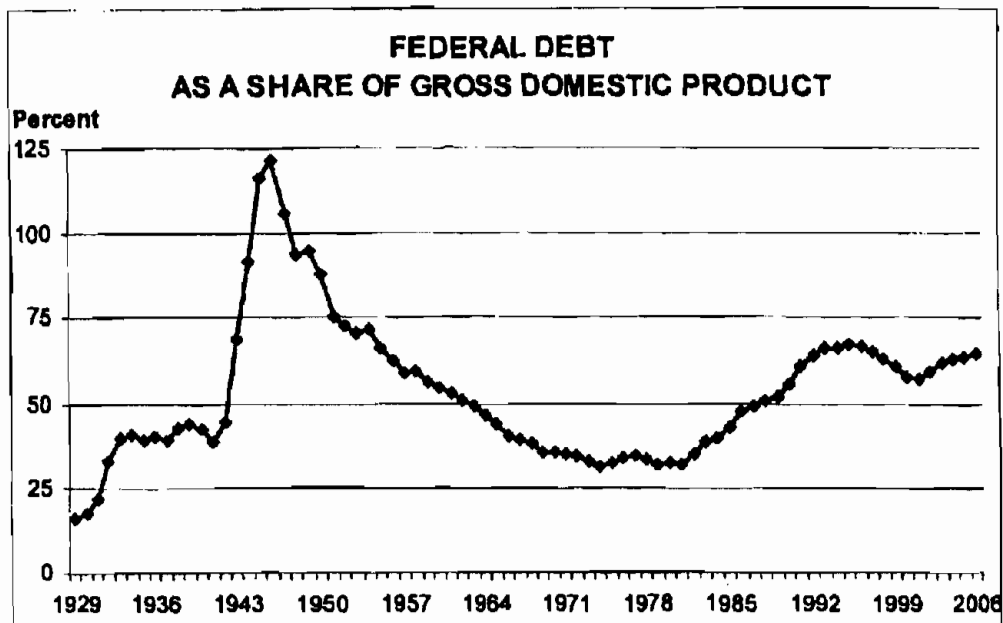
Using debt to finance current consumption bestows benefits on current taxpayers while shifting burdens to future generations. Hence, debt financing should be used only for investments that yield long-term benefits. This allows the cost of the investment that is

FIGURE 1



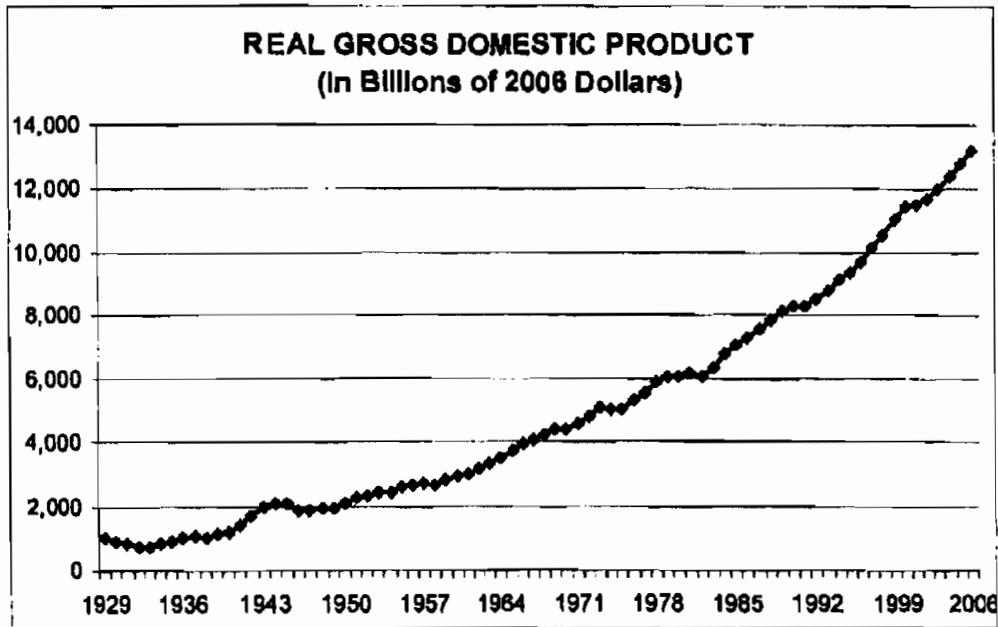
Source: Source: U.S. Department of Treasury.

FIGURE 2



Source: U.S. Department of Treasury and U.S. Department of Commerce, Bureau of Economic Analysis.

FIGURE 3



Source: U.S. Department of Commerce, Bureau of Economic Analysis.

borne by future taxpayers to be matched by benefits of the investment. The result is intergenerational equity.

Investments in enterprises that yield clear economic benefits that offset the prevailing costs of capital are economically efficient. Borrowing when interest costs are historically low is optimal. The decision to invest using debt financing over time is an exercise in weighing costs and benefits.

BORROWING AT THE STATE AND LOCAL GOVERNMENT LEVEL

The principles of public finance discussed in the background section of this report apply to state and local governments as well as to the federal government. Long-term state and local government investments that use debt financing yield long-term benefits that exceed the ongoing costs of capital and achieve intergenerational equity. State and local governments that borrow simply to fund current consumption (with no discernible ongoing benefits) are passing costs on to future generations of taxpayers. However, by the same logic, state and local governments that pay cash today for long-term capital investments are burdening current taxpayers — especially those who will not live to reap the benefits.

State and local governments across the United States issue debt for investments in public infrastructure. The amounts of these investments are reported by the U.S. Census Bureau. In years ending in '2' and '7' the data come from the Census of Governments; in other

years the data are derived from a survey of state and local government finances. The outstanding debt (in nominal dollars) of state and local governments in Arizona is compared to selected states and the national total in Table 1. Comparison states were chosen based on proximity to Arizona and and/or fast growth similar to that of Arizona.

The figures reported by the Census Bureau include public debt for private purposes that are not contained in the annual bonded indebtedness report produced annually by the Governor's office. Rates of change from the bonded indebtedness report are in line with observations from the Census Bureau. Readers interested in knowing the precise amounts of public indebtedness should refer to the annual bonded indebtedness reports. The focus in this report is on the Census Bureau data since they allow comparisons with other states, thereby adding perspective to the discussion of Arizona's debt obligations.

As seen in Table 1, state and local government debt nationally has increased substantially in recent decades. Arizona's debt has risen as well. Outstanding state and local government debt is expressed as a share of gross domestic product by state in Table 2. Just as the comparison of Figures 1 and 2 present different images of federal debt burdens, Table 2 presents a different picture than Table 1 by scaling the debt burdens of state and local governments against the sizes of their economies. Overall shares of debt obligations by state and local governments are far lower than the obligations of the federal government (presented in the far right column of the Table) and have grown at a much slower rate.

Since 1977, debt obligations as a share of gross domestic product by state have increased nationally. In each of the states displayed, a sharp rise in the percentage of debt was followed by a decrease. The difference in the debt percentage between 1977 and 2005 ranges from modestly higher in Georgia and Arizona to substantially higher in Colorado and Utah. In Arizona, the relative debt burden has fallen, almost back to the proportion of 1977, after rising sharply from 1977 to 1987 and reaching a maximum in 1992. Note that the percentage in 1977 was a little above the national average, while the shares in 2002 and 2005 were lower than the U.S. average.

TABLE 1
TOTAL OUTSTANDING DEBT OF STATE AND LOCAL GOVERNMENTS
(Millions of Current Dollars)

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
1977	\$257,532	\$2,851	\$2,195	\$8,158	\$4,169	\$722	\$13,061	\$686
1982	399,290	6,612	5,158	13,134	7,550	1,593	24,343	3,548
1987	718,657	14,103	11,200	40,627	14,253	3,341	53,274	9,119
1992	875,609	19,110	16,295	55,278	20,718	5,789	65,364	10,433
1997	1,221,501	21,252	19,440	70,449	25,884	10,251	78,349	11,991
2002	1,681,377	26,606	28,466	90,316	34,301	15,773	119,226	13,250
2005	2,066,755	32,830	39,108	110,713	37,917	18,494	150,606	14,831

Source: U.S. Department of Commerce, Census Bureau, State and Local Government Finances.

In Table 3, outstanding state and local government debt is expressed in inflation-adjusted dollars per person. From 1982 through 1992, state and local government per capita debt burdens were higher in Arizona than the national average, and higher than in the comparison states other than Utah. However, debt burdens in 2002 and 2005 were well below national norms. Real per capita debt increases in Arizona have not kept pace with that of the nation since 1992 despite the state's growing demands for public infrastructure based on its rapid population growth. Other fast-growing states like Florida and Nevada have taken on debt burdens at a greater rate than has Arizona.

**TABLE 2
OUTSTANDING PUBLIC DEBT AS A SHARE OF GROSS DOMESTIC
PRODUCT**

	Nation- al Total	Arli- zona	State and Local Government					Utah	Federal Debt
			Colo- rado	Florida	Geor- gia	Nevada	Texas		
1977	13.0%	14.7%	8.7%	12.3%	10.2%	9.6%	10.0%	6.6%	34.4%
1982	12.4	18.9	10.9	10.5	11.1	11.2	9.3	19.1	35.1
1987	15.4	23.8	17.8	19.6	12.2	14.9	17.6	36.1	49.6
1992	15.8	24.0	19.1	19.5	13.1	15.9	15.5	29.2	64.1
1997	14.8	16.7	14.6	18.0	10.9	17.1	13.1	21.2	65.2
2002	16.2	15.5	15.6	17.3	11.2	19.4	15.2	18.2	59.5
2005	16.7	15.5	18.2	16.6	10.6	16.8	15.2	16.8	63.8

**TABLE 3
DEBT AND INTEREST PAYMENTS
IN INFLATION-ADJUSTED (2005) DOLLARS**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
1977	\$3,292	\$3,299	\$2,287	\$2,577	\$2,247	\$2,991	\$2,781	\$1,464
1982	3,106	4,123	3,036	2,280	2,408	3,258	2,861	4,102
1987	4,577	6,332	5,301	5,226	3,543	5,038	4,946	8,386
1992	4,978	6,388	6,101	5,300	3,978	5,607	4,817	7,435
1997	5,308	5,316	5,732	5,496	3,991	6,885	4,703	6,702
2002	6,329	5,299	6,861	5,872	4,327	7,886	5,942	6,179
2005	6,970	5,515	8,386	6,231	4,152	7,667	6,569	5,955
	Real Per Capita Interest Payments on Outstanding State and Local Government Debt							
1992	\$332	\$458	\$430	\$353	\$252	\$416	\$343	\$531
1997	313	287	371	342	244	358	286	369
2002	327	277	350	324	215	409	302	307
2005	310	225	373	315	180	355	288	280

Source (Tables 2 and 3): U.S. Department of Commerce, Census Bureau, State and Local Government Finances, and Bureau of Economic Analysis.

Interest payments on the debt also are provided in real per capita terms in Table 3. In part due to reduced interest rates, real per capita interest payments in Arizona from 1997 through 2005 were substantially less than the level in 1992. Nationally, real per capita interest payments essentially were unchanged.

Those expressing concern about the rise in Arizona's debt point to the growth of outstanding debt obligations in recent years. Yet, debt as a share of gross domestic product in Arizona was no higher in 2005 than in 2002, and less than in the preceding years, and per capita interest payments were lower. Applying growth rates from the Governor's public indebtedness reports to the last available Census Bureau figure for 2005 suggests that the outstanding state and local debt figure for Arizona in 2007 might be as high as \$40 billion, including all forms of debt at the combined state and local government level as well as public debt for private purposes. But gross product in Arizona likely eclipsed \$250 billion in 2007, leaving debt as a share of gross product below 16 percent — below 1997 levels and well below levels observed in prior years. This would leave Arizona's debt load below the levels maintained by Nevada, Utah, Florida and Colorado in recent years. Thus, the concern about rising debt in Arizona ignores the rapid acceleration that has taken place in the size of the state's economy and, with it, increased pressures for public infrastructure.

State and Local Government Debt and Economic Performance

The relationship between economic growth and debt financing at the state and local government level can be evaluated by comparing Tables 2 and 3 to Table 4. Average annual real growth in gross domestic product by state for the five years (three years for the 2005 observation) immediately preceding the indicated year is displayed in Table 4. Except for the five years preceding 1992, when Arizona's growth only slightly outpaced the national average, economic growth in Arizona has been considerably greater than the U.S. average. The slower pace of growth relative to the national average in the late 1980s and early 1990s can be traced largely to a severe real estate slump in Arizona and a decline in federal spending for defense goods manufactured in Arizona.

Wide differentials in economic growth between Arizona and the nation were present from the late 1970s through the middle 1980s and again in the mid-1990s, when debt burdens were higher than the national average. Since the mid-1990s, the differential in economic growth rates between Arizona and the nation have been smaller, at a time when debt burdens dropped below the national average. Having a debt burden that was very high in comparison with the rest of the nation and with comparison states in 1992 did not prevent Arizona from being among the leaders in economic growth over the subsequent five-year period. Indeed, the debt obligations of the 1970s and 1980s provided public infrastructure that may have helped fuel economic growth during that period and into the succeeding period.

The data suggest that relatively high debt loads do not necessarily impede economic growth. The argument for taking on additional debt needs to be made on the merits of the infrastructure investment, such as a sound investment that will yield long-term economic

**TABLE 4
AVERAGE ANNUAL GROWTH IN REAL GROSS DOMESTIC PRODUCT**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
1982	0.8%	3.0%	3.9%	3.9%	1.4%	4.0%	5.2%	2.7%
1987	4.4	7.7	2.6	7.3	7.9	6.1	-0.3	3.2
1992	2.3	2.7	2.8	3.1	2.8	6.7	3.4	3.7
1997	3.8	7.7	7.2	4.5	6.3	8.2	5.2	7.5
2002	2.9	4.3	4.6	4.1	3.4	4.4	3.7	3.3
2005	3.1	4.4	2.8	5.5	2.5	7.7	5.2	3.9

Source: U. S. Department of Commerce, Bureau of Economic Analysis.

benefits, and considerations of costs and benefits at a particular point in time, such as the costs of capital finance and construction.

INFRASTRUCTURE NEEDS IN ARIZONA

The pace of investments in, and financing of, infrastructure in Arizona has been much discussed in recent years. Major reports on the state's future transportation needs and broad public and private utility infrastructure needs are scheduled for release this year. One issue is whether the public sector has provided public infrastructure sufficient to support current and impending population growth. A second issue is whether private utilities have been provided the opportunity by regulators to price service delivery at levels that allow them to put requisite infrastructure in place. The current discussion pertains to the first issue and will be confined to items categorized in the general fund of state and local governments, including education, transportation, and public safety. Issues of water, power, communications and other infrastructure that are delivered by a mix of public, private, and quasi-public entities will be considered in a separate report.

Population growth in Arizona, the nation, and comparison states is presented in Table 5. The growth rate in Arizona has been eclipsed only by Nevada in recent years. The somewhat lesser percentage gains in Arizona in recent years result from the increasing size of the state's population; numeric population gains rose during the 1990s and 2000s.

The pace of public service delivery to serve growing populations in the comparison states can be examined historically from the Census Bureau data on state and local government finances. Table 6 presents government general fund spending on a real per capita basis (top panel) and as a share of gross product (bottom panel) for Arizona, the nation, and the group of comparison states. General expenditures span education, transportation, public health and welfare, public safety, environment and natural resources, and general government functions. Expenditures for current operations and capital outlays are included. Financing sources include taxes and other revenues of state and local governments, federal funds distributed to state and local governments, and borrowing.

The data in Table 6 indicate that Arizona's per capita spending from 1977 through 1992 was nearly equal to the national average and ranked second or third among the states displayed. As a share of gross product, Arizona was above the national average and ranked first or second among the seven states. By 1997, and continuing in 2002 and 2005, Arizona had fallen well below the national average on both measures. It was lowest among the seven states on per capita expenditures, and third on share of gross product.

Public expenditures for education, from preschool through graduate school, are compared in Table 7. Again, the expenditure data include current operations and capital outlays by

**TABLE 5
AVERAGE ANNUAL PERCENTAGE GROWTH IN POPULATION**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
1982	1.1%	3.6%	2.6%	3.3%	1.6%	5.4%	3.1%	3.4%
1987	0.9	3.5	1.3	2.8	1.9	3.0	1.6	1.5
1992	1.1	2.6	1.4	2.6	1.9	5.7	1.3	1.8
1997	1.2	3.9	2.8	2.2	2.4	5.5	2.1	2.9
2002	1.1	2.8	2.3	1.9	2.3	4.2	2.0	1.9
2005	1.0	3.0	1.2	2.1	2.0	3.6	1.8	2.3

Source: U.S. Department of Commerce, Census Bureau.

**TABLE 6
STATE AND LOCAL GOVERNMENT GENERAL FUND EXPENDITURES**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
Per Capita Inflation-Adjusted (2005) Dollars								
1977	\$3,489	\$3,356	\$3,647	\$2,839	\$2,749	\$3,728	\$2,747	\$3,201
1982	3,372	3,180	3,355	2,788	3,030	3,679	2,832	3,122
1987	4,163	4,265	4,402	3,640	3,704	4,222	3,621	3,954
1992	4,988	4,613	4,867	4,535	4,301	5,133	4,127	4,133
1997	5,421	4,452	5,160	4,946	5,041	5,306	4,586	5,030
2002	6,522	5,139	6,556	4,733	5,841	5,900	5,552	6,015
2005	6,778	5,527	6,219	6,343	5,552	6,177	5,728	5,823
Expenditures as a Share of Gross Domestic Product								
1977	13.7%	15.0%	13.9%	14.0%	12.5%	12.0%	9.9%	14.4%
1982	13.5	14.6	12.0	13.0	13.9	12.6	9.2	14.6
1987	14.0	16.1	14.8	13.7	12.8	12.5	12.9	17.0
1992	15.8	17.3	15.3	16.7	14.2	14.5	13.3	16.3
1997	15.1	14.0	13.2	16.2	13.8	13.2	12.7	15.9
2002	16.7	15.0	14.9	13.9	15.1	14.5	14.2	17.8
2005	16.2	15.5	13.5	16.9	14.1	13.5	13.3	16.4

Source: U.S. Department of Commerce, Census Bureau, State and Local Government Finances, and Bureau of Economic Analysis.

state and local governments. The evidence in Table 7 is similar to that of overall spending. Arizona spent significantly on education from the 1970s into the 1990s but more recently has lagged the nation and most comparison states — especially in real per capita spending.

Highway spending by state and local governments — almost exclusively spending that provides multiyear benefits — appears in Table 8. The spending represents all expenditures from state and local sources: taxes and other revenues, borrowing, and federal assistance.

The data in Table 8 convey a story consistent with that of education and overall spending. Highway investments across the state were relatively large through 1992. The Maricopa County freeway investment is especially prominent in 1987. However, in more recent years, investments in highways to provide for current and impending population growth have lagged the nation and other fast-growing states — especially when the comparison is based on real per capita measures.

A focus on capital outlays provides additional perspective. Data are available since 1992 and include all capital outlays, including lease-purchase contracts, for combined state and local governments. Construction of schools, roads, public hospitals, correctional facilities, parks and recreational facilities, sewers, solid waste disposal facilities, and

**TABLE 7
STATE AND LOCAL GOVERNMENT GENERAL FUND EXPENDITURES
ON EDUCATION**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
Per Capita Inflation-Adjusted (2006) Dollars								
1977	\$1,314	\$1,504	\$1,667	\$1,074	\$1,024	\$1,243	\$1,192	\$1,707
1982	1,202	1,372	1,412	984	989	2,248	1,175	1,503
1987	1,444	1,816	1,808	1,158	1,293	1,206	1,467	1,655
1992	1,657	1,604	1,722	1,410	1,402	1,550	1,614	1,781
1997	1,821	1,551	1,887	1,459	1,788	1,612	1,825	2,012
2002	2,239	1,753	2,169	1,877	2,195	1,850	2,278	2,425
2005	2,325	1,831	2,166	1,801	2,179	1,865	2,303	2,209
Expenditures as a Share of Gross Domestic Product								
1977	5.2%	6.7%	6.4%	5.1%	4.7%	4.0%	4.3%	7.7%
1982	4.8	6.3	5.1	4.5	4.5	7.7	3.8	7.0
1987	4.9	6.1	5.4	4.4	4.5	3.6	5.2	7.1
1992	5.3	6.0	5.4	5.2	4.6	4.4	5.2	7.0
1997	5.1	4.9	4.8	4.8	4.9	4.0	5.1	6.4
2002	5.7	5.1	4.9	4.9	5.7	4.6	5.8	7.2
2005	5.6	5.1	4.7	4.8	5.6	4.1	5.3	6.2

Source: U.S. Department of Commerce, Census Bureau, State and Local Government Finances, and Bureau of Economic Analysis.

**TABLE 8
STATE AND LOCAL GOVERNMENT GENERAL EXPENDITURES
ON HIGHWAYS**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
Per Capita Inflation-Adjusted (2005) Dollars								
1977	\$295	\$347	\$313	\$221	\$289	\$414	\$234	\$427
1982	268	312	294	224	319	409	329	231
1987	332	584	379	270	298	452	371	368
1992	344	368	412	328	269	387	295	285
1997	357	325	413	359	293	470	294	447
2002	434	378	675	438	366	650	364	466
2005	418	353	472	450	197	663	432	361
Expenditures as a Share of Gross Domestic Product								
1977	1.2%	1.5%	1.2%	1.1%	1.2%	1.3%	0.8%	1.9%
1982	1.1	1.4	1.1	1.0	1.5	1.4	1.1	1.1
1987	1.1	2.2	1.3	1.0	1.0	1.3	1.3	1.6
1992	1.1	1.4	1.3	1.2	0.9	1.1	0.9	1.1
1997	1.0	1.0	1.1	1.2	0.8	1.2	0.8	1.4
2002	1.1	1.1	1.5	1.3	0.9	1.6	0.9	1.4
2005	1.0	1.0	1.0	1.2	0.5	1.5	1.0	1.0

Source (Tables 7 and 8): U.S. Department of Commerce, Census Bureau, State and Local Government Finances, and Bureau of Economic Analysis.

buildings to house general government operations are included in the capital outlay figures (see Table 9).

The trends observed in the expenditure categories discussed above prevail with capital outlay expenditures. In 1992, Arizona was above the national average in real per capita outlays and ranked third among the seven states. Capital outlay expenditures as a share of the Arizona economy were the highest among the comparison states in 1992. Since then, Arizona has ranked sixth or seventh on per capita expenditures and fourth to sixth as a share of gross product. Capital outlays were below the national average on a real per capita basis in 2002 and 2005, despite the state's continued much more rapid growth. Capital outlays as a share of gross product were 0.6 percentage points less in 2002 and 2005 than in 1992.

An Independent Assessment of Infrastructure Needs

The American Society of Civil Engineers reported serious deficiencies with respect to Arizona's schools in its 2005 report card on infrastructure assessment for the state:

- 64 percent of Arizona's schools have at least one inadequate building feature.
- 69 percent of Arizona's schools have at least one unsatisfactory environmental condition.

**TABLE 9
STATE AND LOCAL GOVERNMENT GENERAL FUND EXPENDITURES
ON CAPITAL OUTLAYS**

	National Total	Arizona	Colo- rado	Florida	Georgia	Nevada	Texas	Utah
Per Capita Inflation-Adjusted (2005) Dollars								
1992	\$463	\$587	\$829	\$513	\$455	\$740	\$417	\$438
1997	561	591	647	593	599	907	466	755
2002	787	716	956	851	861	968	795	860
2005	817	806	901	934	868	1,161	912	843
Expenditures as a Share of Gross Domestic Product								
1992	1.9%	2.9%	2.6%	2.5%	2.0%	2.7%	1.8%	2.2%
1997	1.9	2.2	2.0	2.3	1.9	2.7	1.5	2.8
2002	2.2	2.3	2.4	2.7	2.4	2.6	2.2	2.8
2005	2.0	2.3	2.0	2.5	1.7	2.5	2.1	2.4

Source: U.S. Department of Commerce, Census Bureau, State and Local Government Finances, and Bureau of Economic Analysis.

At the same time, Arizona's burgeoning school-age population is placing huge demands on the need for new buildings. With 3 percent annual growth in the elementary and secondary school population projected through 2020, some 37 million additional square feet in space will be required. According to a recent report to the Board of Regents, the state's universities will require over 14 million new square feet by 2020, with considerable portions devoted to costly research laboratory space. The cost of elementary, secondary, and university construction easily could exceed \$15 billion (in inflation-adjusted dollars), not considering the recent acceleration in the cost of construction. These estimates do not include the needs of community colleges, which have received increased pressure to deliver programs that develop specific technical expertise to an ever-changing labor market landscape.

The American Society of Civil Engineers also reported serious deficiencies with respect to Arizona's highways, along with estimates of costs borne by citizens as a result of these deficiencies:

- Twenty-nine percent of Arizona's major urban roads are congested.
- Vehicle travel on Arizona's highways increased 52 percent from 1990 to 2003, comparable to the population increase.
- Driving on roads in need of repair costs Arizona motorists \$459 million a year in extra vehicle repairs and operating costs — \$120 per motorist annually.
- Congestion in the Phoenix metropolitan area costs commuters \$812 per person per year in excess fuel cost and lost time.
- Congestion in the Tucson area costs commuters \$507 per person per year in excess fuel cost and lost time.

The estimated costs for addressing these needs have yet to be established, but failure to keep pace with highway needs in recent years may prove very costly to Arizona

taxpayers. The costs are borne regardless of policy action — either in the costs of congestion or in the expenditures required to ameliorate the congestion pressures.

The American Society of Civil Engineers also reported:

- Arizona has almost \$6.2 billion in wastewater infrastructure needs.
- Arizona generates 1.10 tons of solid waste per capita.

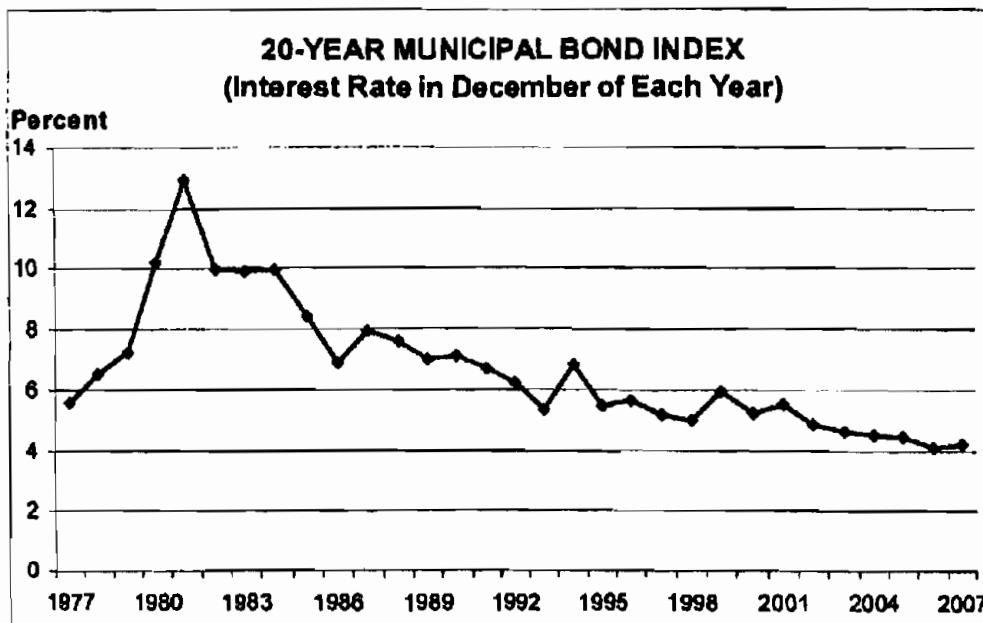
The modest pace of general expenditures in recent years has exacerbated these problems.

Thus, the relatively slow pace of spending in Arizona in the face of economic and demographic pressures has been manifested in some pressing public infrastructure needs. While the focus of this report is on public-sector infrastructure, there is no reason to believe that infrastructure needs in the private and quasi-public energy, water, and communications sectors are not equally pressing.

Timing Considerations

Debt financing is much less costly when interest rates are low and when construction costs have moderated due to the construction sector being in the trough of its cycle. Figure 4 presents municipal bond rates historically. Interestingly, when Arizona's state and local government debt levels were considerably higher in the late 1970s and 1980s, the cost of capital was considerably higher than today. The cost of acquiring debt currently is at a historically low level.

FIGURE 4



Source: Federal Reserve Board and Economagic.com.

A sharp downturn in residential construction currently is underway. While commercial construction has held up well to date, some real estate experts have noted that most of the current activity is the result of plans put in place several years ago. Few new big-ticket projects have been planned recently. This follows the typical cycle and suggests that the pace of commercial construction will wane over the next year or two — just as the economy struggles to lift itself from the current downturn.

Plans formulated today by state and local governments to address infrastructure needs may prove very timely. The debt could be acquired at historically low interest rates and the publicly financed construction would occur at the trough of the private-sector construction cycle.

Using debt financing purely as a tool to stimulate economic growth is not necessarily a prudent use of credit markets. However, if the debt is used to address real infrastructure needs, and the construction of facilities yield long-term benefits, an added benefit of debt financing is a boost to the economy, particularly to a slumping construction sector.

As an example, using the input-output model IMPLAN to assess the effects of a \$1.2 billion university construction proposal, economists estimated an impact of \$1.6 billion in total economic activity and 26,655 jobs while the project was being constructed. The authors noted that an assessment of the overall impact should include the opportunity costs of funds, alternative uses of the money, and other issues. If debt finance were used to pay for this activity now, borrowing costs would be minimized, the construction stimulus would occur when most needed, and benefits and costs would be distributed across current and future taxpayers.

CONCLUDING THOUGHTS

That Arizona state and local governments may be positioned to take on more debt load without placing the state in a position where it is overly debt laden relative to other state and local governments or relative to historical conditions is not in itself a rationale for taking on more debt. Following the principles of public finance discussed earlier, debt should be taken on only to finance those projects that yield long-term benefits to future citizens and when capital markets offer favorable terms regarding costs and benefits of each project.

Arizona's explosive population growth has resulted in pressing needs for infrastructure and public services. From 1992 through 2005, the state accounted for more than 5 percent of the nation's population growth — one in 20 new U.S. residents was an Arizonan. Over the same period, state and local governments in Arizona expended less than 2 percent of the nation's total capital outlays for public infrastructure. The imbalance has manifested itself in a need for new education facilities, new highways, and other public infrastructure.

While population and economic growth has remained strong — the current downturn is cyclical in nature — it is unclear whether the standard of living and quality of life can be

maintained. The pace of public infrastructure investments will dictate how well future growth will be accommodated.

Prudent use of the debt financing capacity that Arizona enjoys can allow citizens to address these infrastructure needs without resorting to tax rate increases. While the cost of capital is at historic lows, Arizona state and local policymakers could follow the lead of many in the private sector and use capital markets efficiently and in a timely manner that promotes intergenerational equity to address the pressing public-infrastructure needs.