
Revenue and Budget Update

Arizona Tax Research Association

November 21, 2014

JLBC

Summary of Current Budget Status

- ❑ At the end of May, the projected current year ('15) ending balance was \$130 M – but '16 had a \$(237) M shortfall
- ❑ Revenue growth has slowed considerably in the interim, and the new forecast is more cautious
- ❑ As a result, shortfalls are now projected in both years:
 - \$(189) M in '15 and \$(667) M in '16
- ❑ The Superior Court K-12 inflation ruling would further increase the budget gap:
 - \$(520) M in '15 and \$(1.0) B in '16

Implications of FAC Update and K-12 Litigation

- Does Not Reflect Impact if Litigation Back Payments Are Awarded

Potential Ending Balance Estimates \$ in M

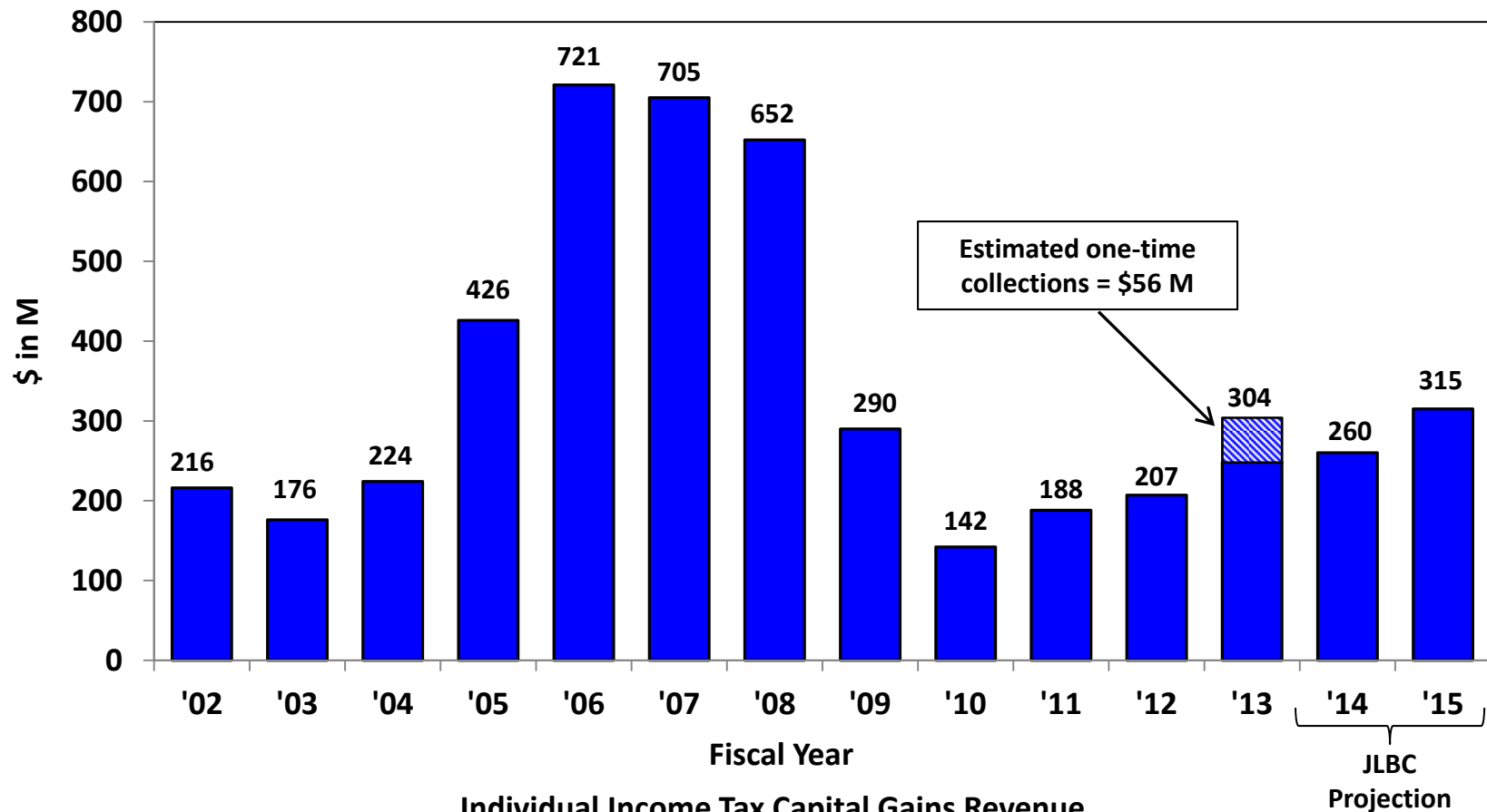
<u>After:</u>	<u>'15</u>	<u>'16</u>
• May Special Session	\$130	\$(237)
• October FAC Update	(189)	(667)
• FAC Update + K-12 Reset	(520)	(1,002)

- ❑ Estimates assume that '15 shortfall is resolved with 1-time solutions prior to '16

The Caveats

- ❑ '14 again demonstrated the challenge in forecasting revenues accurately
 - 1% error across 3 years changes balance by \$575 M
 - Some revenue sources inherently volatile
- ❑ AZ revenue performance at odds with recent favorable US economic news
 - If national momentum is sustained, there is upside potential for AZ by Spring
 - Higher growth would help, but not resolve, the shortfall. If growth was a “strong” 7% in '16, shortfall declines \$(267) M.

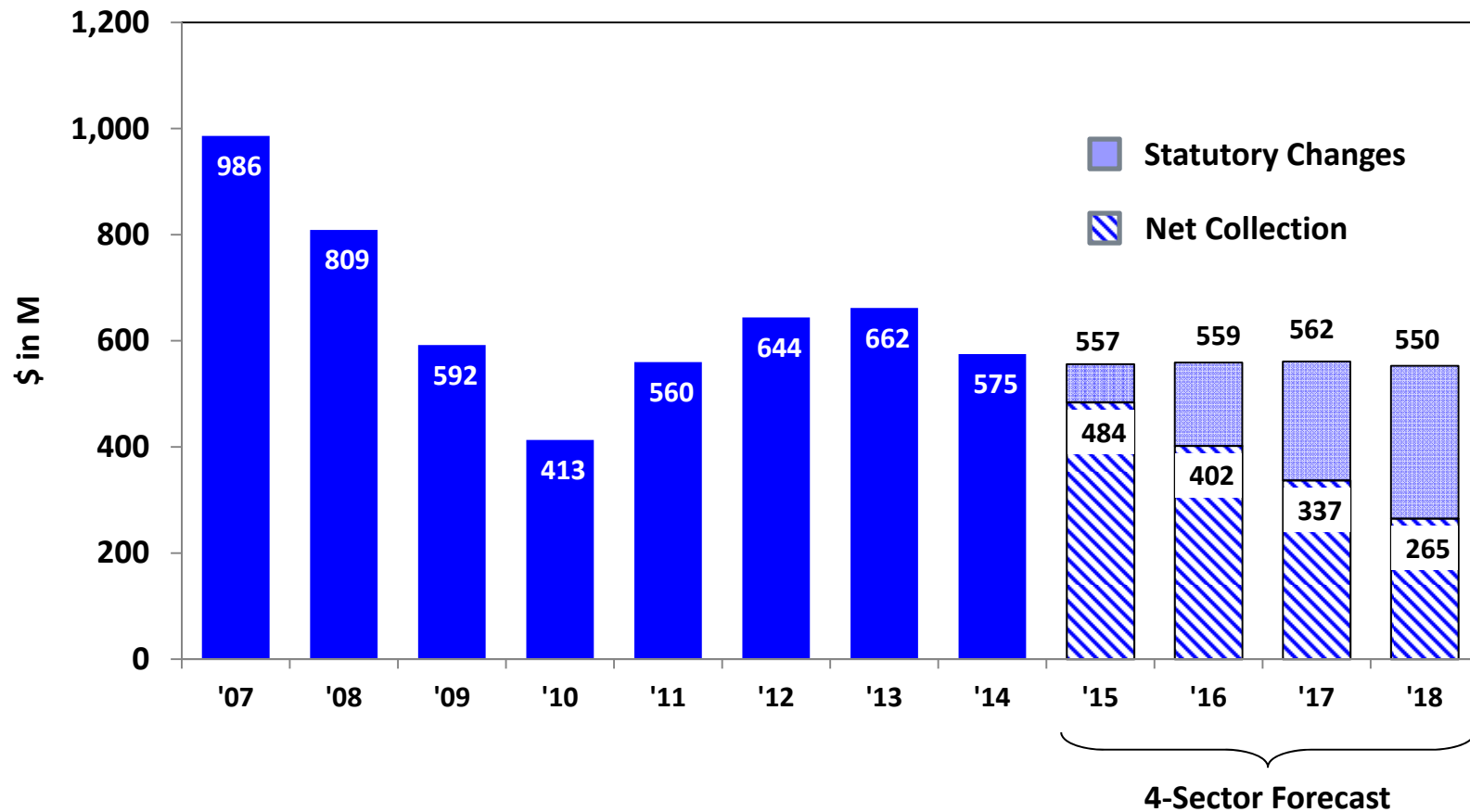
Capital Gains Complicate Income Tax Forecasting



Individual Income Tax Capital Gains Revenue
'14 and '15 Not Adjusted for Tax Law Changes



Corporate Income Tax Collections Have Been Volatile



Corporate Income Tax Collections

Revenue Forecast

Arizona's Current Economic Challenges

- Given Our Size, Historical Norm May Not be Realistic

- ❑ Annual 2% job growth – historical norm of 3.9%
- ❑ Flat wages
- ❑ 1% - 1.5% population growth – historical norm of 3.1%
- ❑ 18,000 building permits in last year – historical norm of 38,000
- ❑ U.S. household formation declining
- ❑ Federal defense contract reductions

Revenue Growth Near 3% for Last 16 Months

	<u>'14 Budgeted</u>	<u>'14 Actual</u>	<u>'15 1st Trimester</u>
Sales	5.7%	5.5%	3.0%
Individual Income	3.7%	1.9%	1.8%
Corporate Income	(3.5)%	(13.1)%	6.8%
Overall	3.9%	2.7%	3.6%

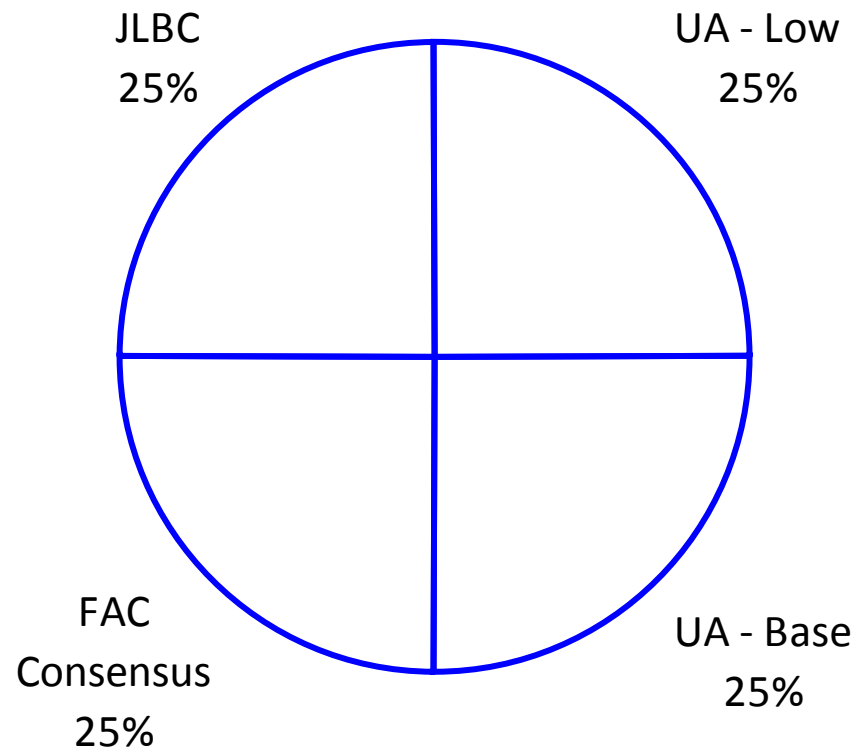
- ❑ With October estimates, revenues have been below forecast for 7 consecutive months
- ❑ '14 revenues \$(86) M short of forecast, '15 already \$(72) M short of enacted forecast

Where Are We Headed Over the Next Few Years?

- Four-Sector Consensus Forecast Incorporates Different Economic Views, Including the FAC

4-sector forecast equally weights:

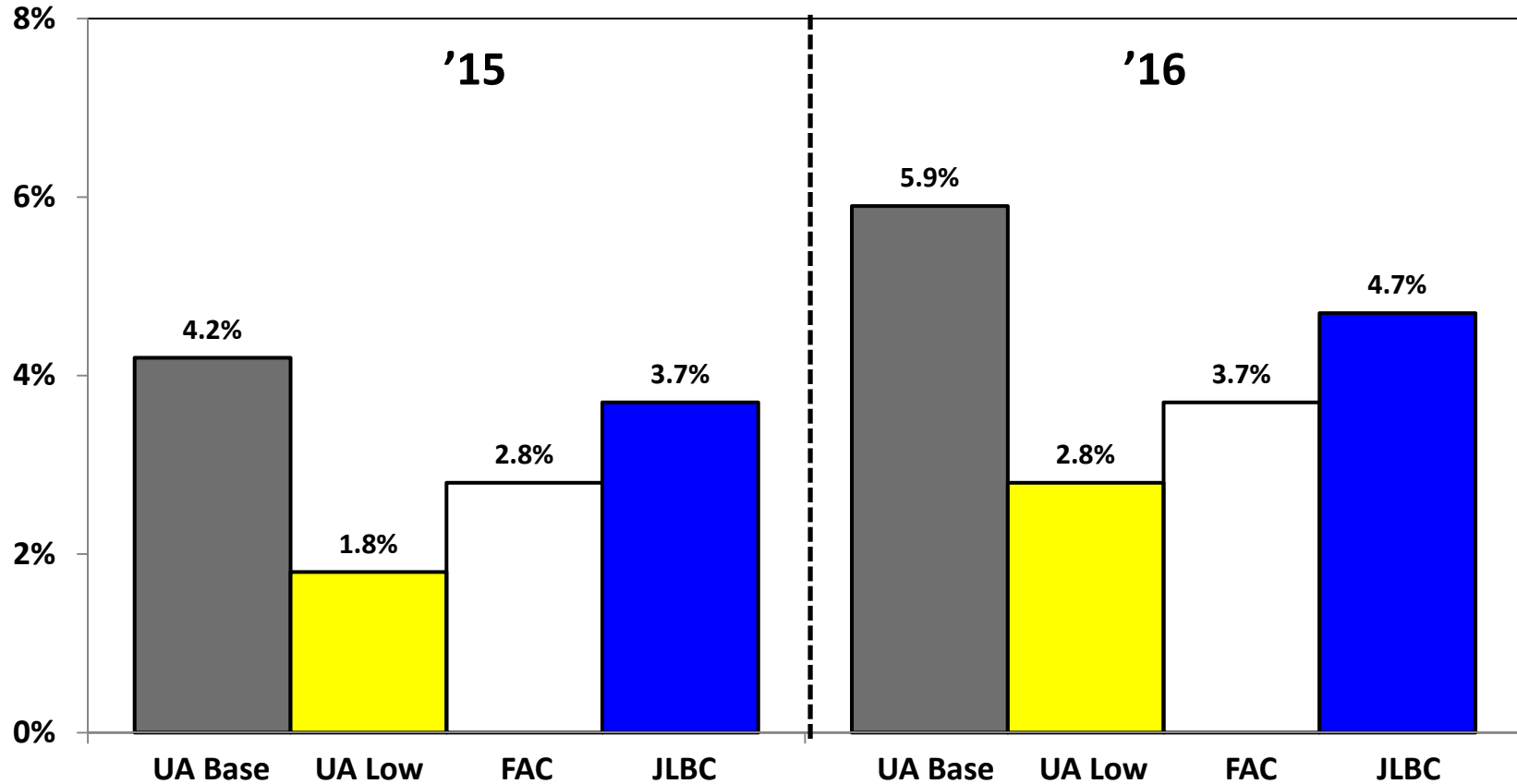
- FAC average
- UofA model – base
- UofA model – low
- JLBC Staff forecast
- Remaining revenues (8% of total) are staff forecast



* Includes Big 3 categories of sales tax, individual income and corporate income taxes

Overall Consensus Growth Rate

- 3.4% in '15 and 4.1% in '16



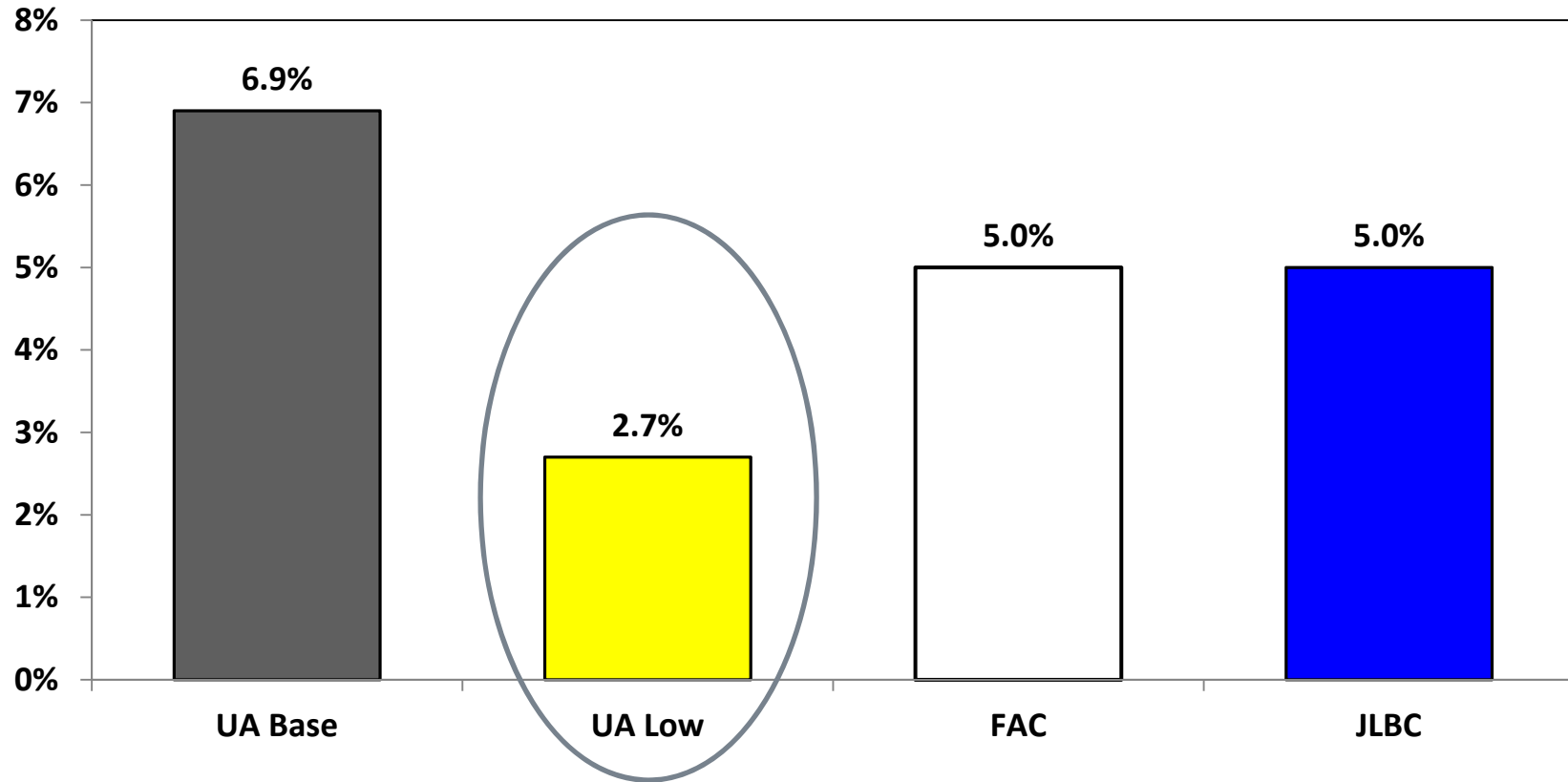
Details in Appendix A

Prior to adjusting for small tax categories, the Big 3 base growth rate is 3.1% in '15 and 4.3% in '16



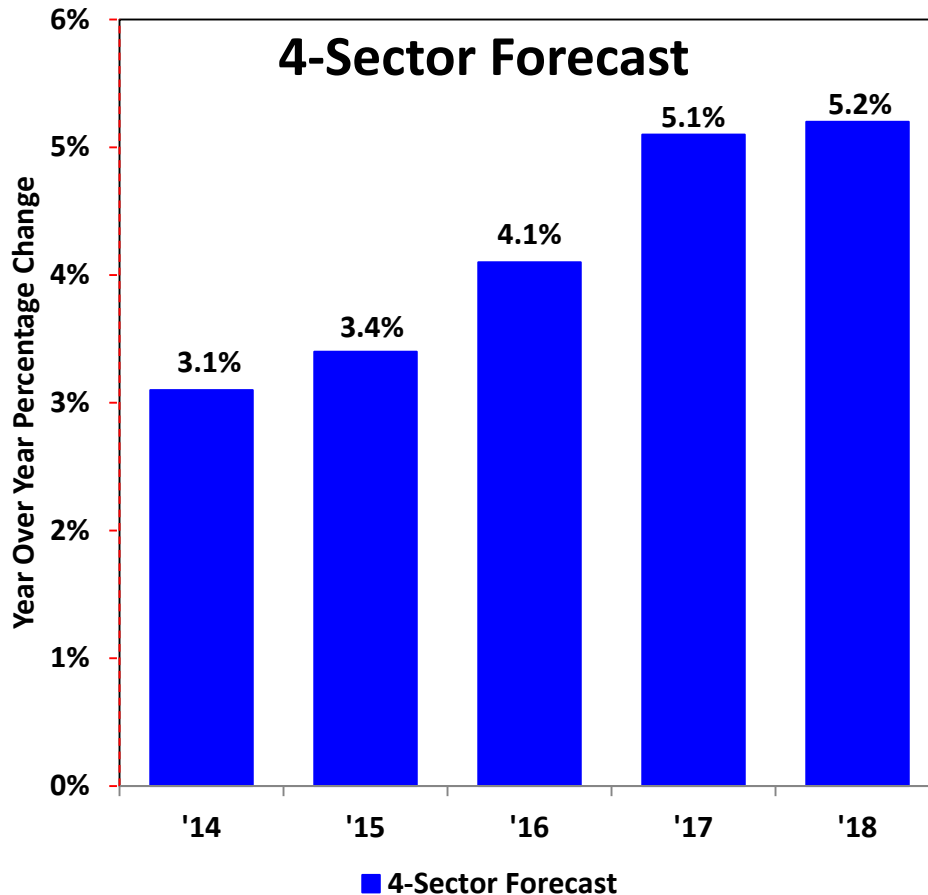
Predicting 3.1% '14 Growth

- UA Low Forecast was the Closest



April 2013 Forecast
Modified for Small Categories

Slow Growth Predicted Through '16; 5% in '17 & '18



Percent Change in Base revenues excluding balance forward, statutory changes, one-time revenues, and urban revenue sharing

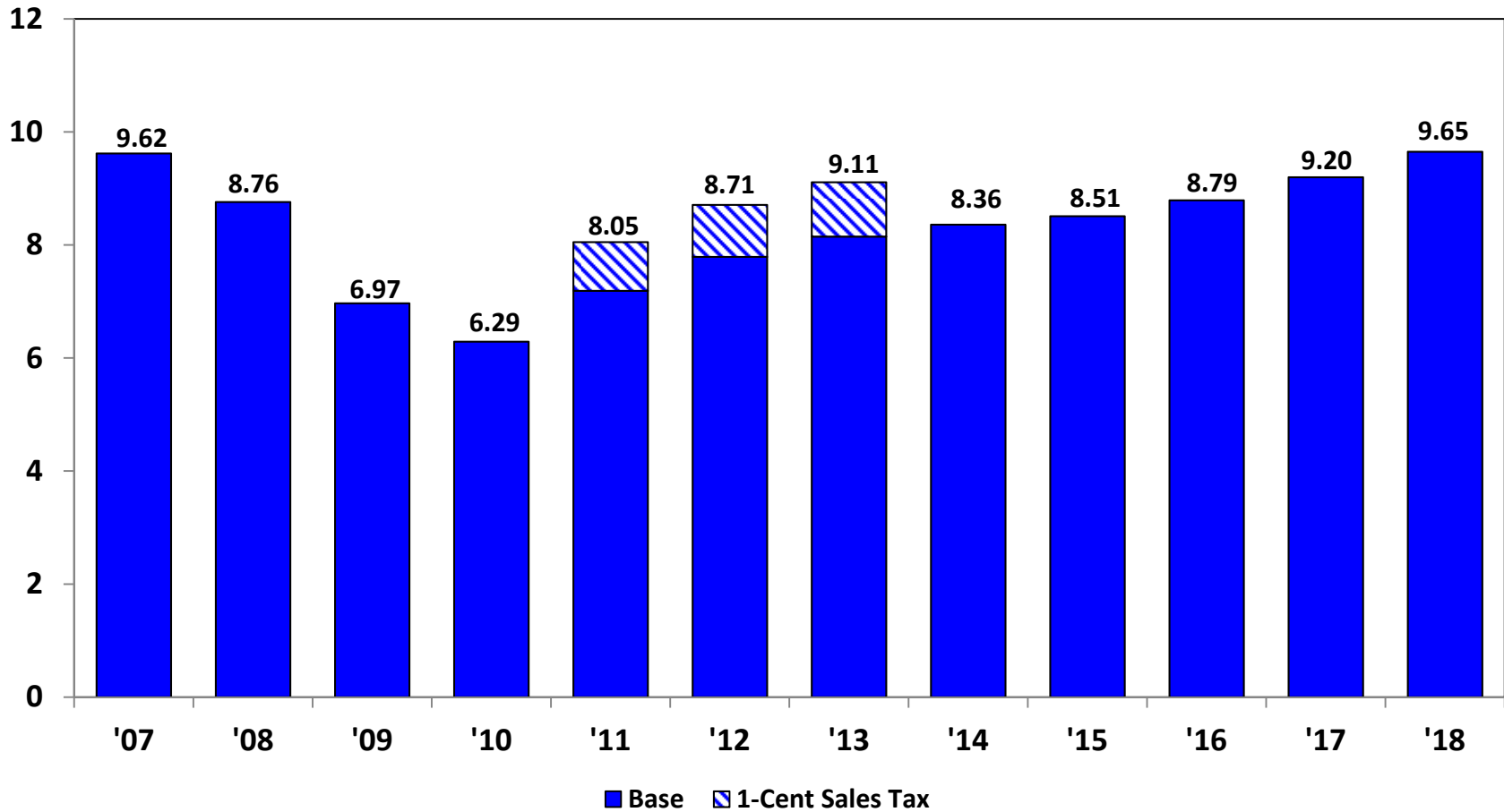
- Was '14 an outlier or a precursor?
- 3.6% 1st Trimester '15 Growth
- Higher-than-average chance that forecast improves by Spring

Phase-In of \$226 M of Enacted Tax Reductions

	\$ in M		
	<u>'16</u>	<u>'17</u>	<u>'18</u>
<input type="checkbox"/> Corporate Rate Reduction/Sales Factor	(57)	(50)	(48)
<input type="checkbox"/> 25% Capital Gains Reduction	(12)	0	0
<input type="checkbox"/> 1-time Income Tax Indexing	(6)	6	0
<input type="checkbox"/> Corporate School Tuition Indexing	(9)	(10)	(12)
<input type="checkbox"/> Other	(16)	(7)	(5)
Total	<u>(100)</u>	<u>(61)</u>	<u>(65)</u>

By '18, revenue base is forecast to be a total of \$226 M lower than if no enacted changes

The Last Decade of General Fund Revenues



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



Spending Forecast

Updated '16 – '18 Spending Projections

- ❑ Enacted budget figures have been updated to reflect latest estimated changes to currently active statutory and other funding formulas
- ❑ Spending estimates assume the continued annual suspension of \$374 M of inactive formulas – mostly ADE funding
- ❑ Assumes continuation of \$1.2 B in “rollover” payments
- ❑ Assumes no discretionary spending increases

Projected Baseline Spending Changes

	\$ in M		
	<u>'16</u>	<u>'17</u>	<u>'18</u>
K-12 Formula	175	209	162
Medicaid Formula	57	117	131
DCS 1-Time Backlog	(11)	(8)	0
ADC Operating	8	(1)	0
Capital	(45)	0	0
HURF Shift (\$30 M to \$60 M)	0	30	0
One-Time/Other	(62)	(6)	3
Additional Spending	<u>122</u>	<u>341</u>	<u>296</u>
Total Spending	\$9,451	\$9,792	\$10,088
K-12 Inflation Reset	\$336	\$341	\$346
Revised Total	\$9,787	\$10,133	\$10,434

Projected Ending Balance Estimates

Updated '15 – '18 Ending Balance Projections

- October FAC Revenue With Updated Agency Caseload

Baseline	'15	'16	'17	'18
Balance Forward	\$577 M	--	--	--
Revenues	\$8.56 B	\$8.78 B	\$9.20 B	\$9.65 B
Spending	\$9.66 B	\$9.79 B	\$10.13 B	\$10.43 B
Ending Balance	\$(520) M	\$(1.0) B	\$(928) M	\$(787) M

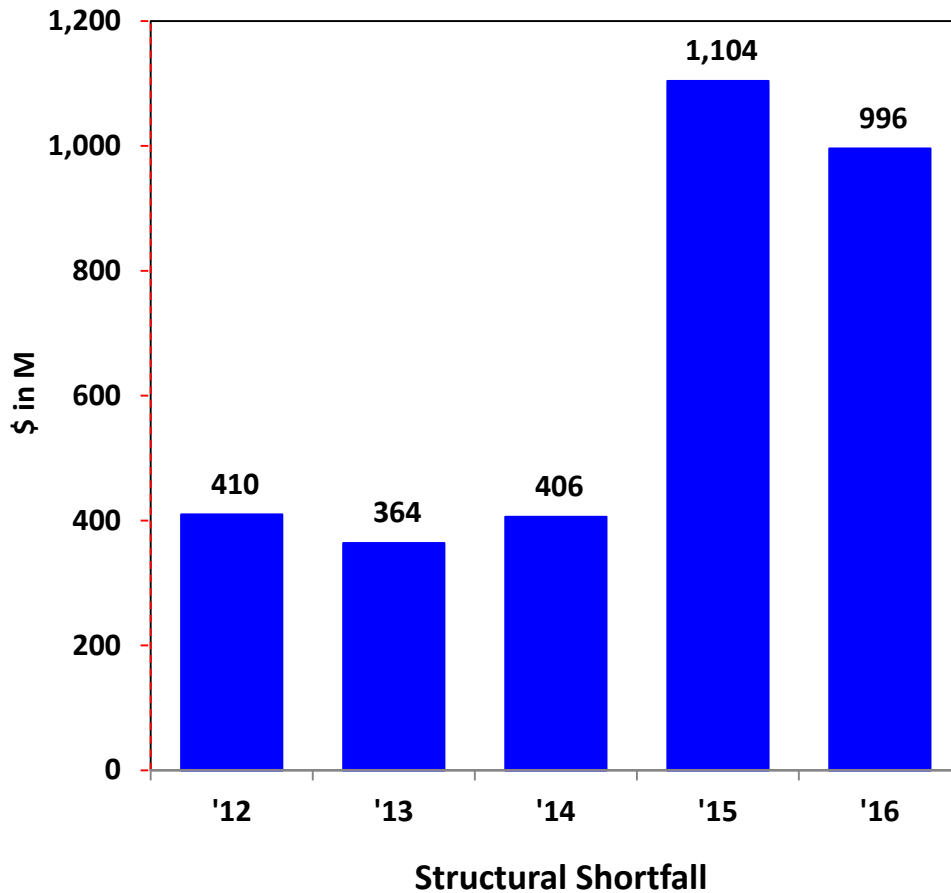
- ❑ Includes \$336 M K-12 inflation reset
- ❑ Without reset, '15 shortfall is \$(189) M and '16 is \$(667) M
- ❑ Does not include \$460 M Rainy Day Fund

The Path from a Healthy Surplus to a Large Shortfall

- Even Without the K-12 Litigation

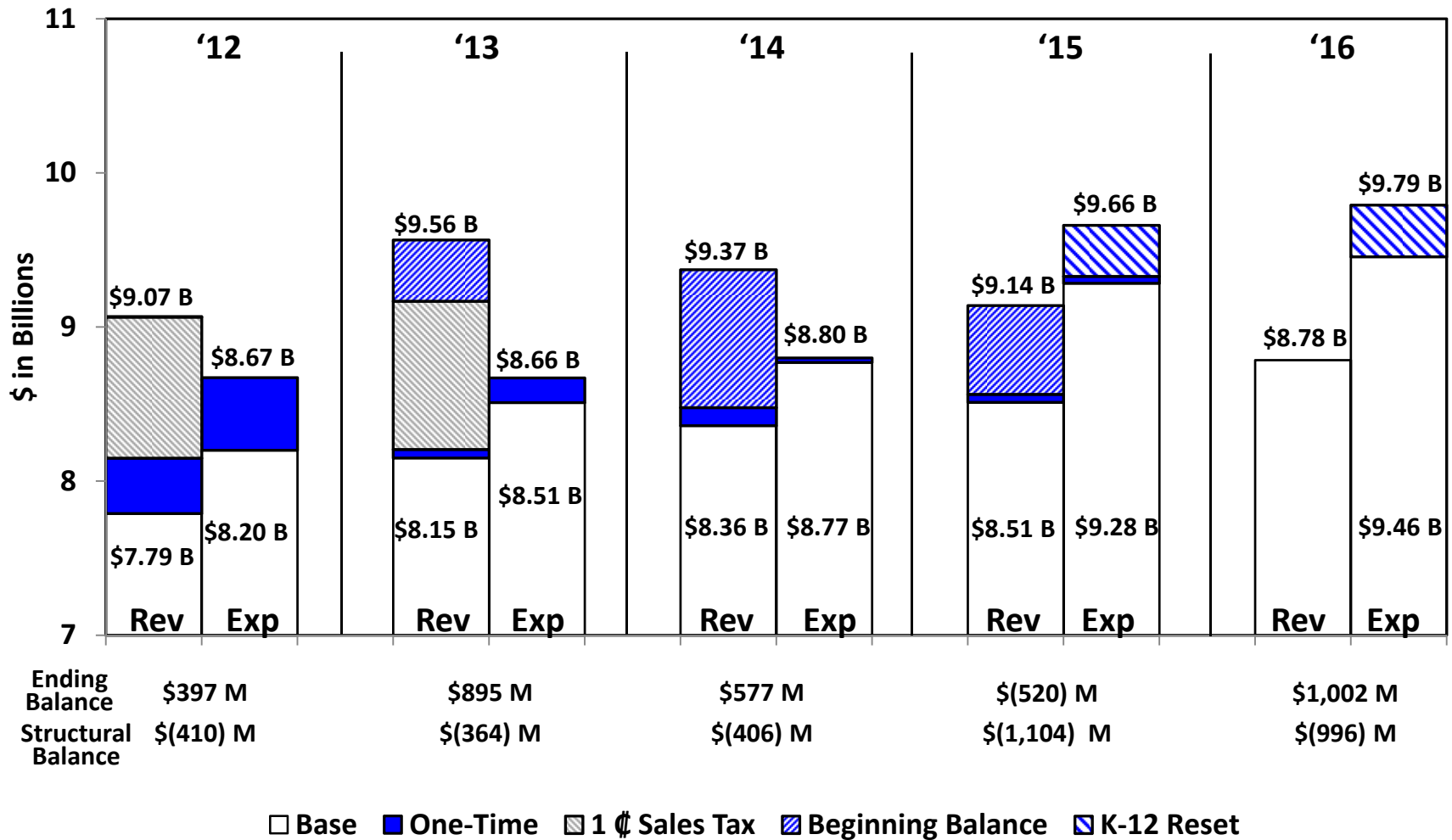
- ❑ The state never resolved its underlying structural shortfall
- ❑ When the \$900 M 1-cent sales tax ended in '13, we replaced it with a \$900 M 1-time carryforward in '14
- ❑ Insufficient attention to the statutory 3 year planning estimates -- we enacted a '15 budget with projected shortfalls of \$(237) M in '16 and \$(490) M in '17
- ❑ 3% revenue growth compared to budgeted 4%-5% growth
- ❑ K-12 litigation
- ❑ Long term commitments significantly in advance of paying the cost

The Ongoing Structural Shortfall Helped Create the Current Problem



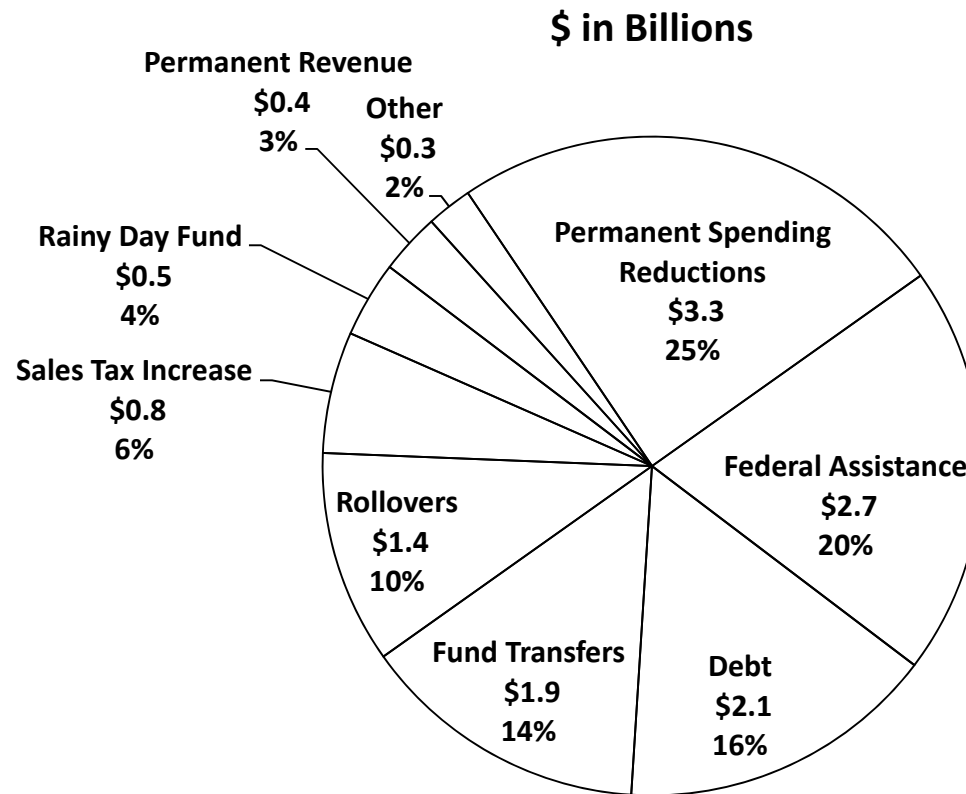
- Reflects only ongoing revenue and spending
- 1-cent sales tax and carryforward kept '12-'14 balanced

The Structural Gap Details



How Will the Current Shortfall be Resolved?

- In '08 - '12, Most of the Solutions were One-time



Perspectives on Spending Reduction Options

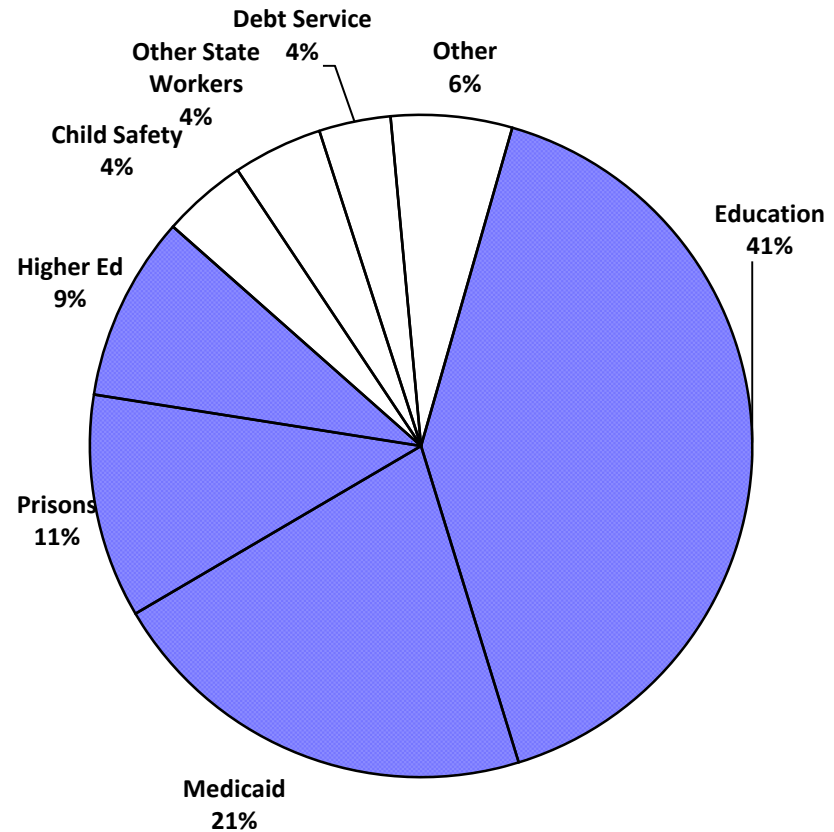
- ❑ General Fund spending is concentrated in only a few agencies
- ❑ Most General Fund agencies are still below their '08 fund level

The 3 Main Drivers of General Fund Spending: Education, Health, and Prisons

- Represents 82% of '15 On-Going General Fund Budget



	<u>\$ in Millions</u>
K-12 Education	\$ 3,808.4
Medicaid	1,989.8
Prisons	1,021.2
Higher Ed	843.3
Other State Workers	408.6
Child Safety	386.0
Debt Service	326.7
Other	<u>552.0</u>
Total Spending	\$ 9,336.0



Current General Fund Spending \$(1.1) B Below '08

- Represents (11)% Reduction

<u>64 Agencies Spend Less, including:</u>	<u>\$ Change (M)</u>	<u>% Change</u>
• School Facilities	(343)	(64)%
• Community Colleges	(96)	(57)%
• Universities	(353)	(31)%
• DES	(106)	(18)%
• ADE (SETR Adjusted)	(327)	(8)%

'08-'15 Comparison

- Part 2

<u>21 Agencies Spend More, including:</u>	<u>\$ Change (M)</u>	<u>% Change</u>
• AHCCCS	5	0.4%
• DHS	29	5%
• ADC	87	10%
• Child Safety	175	83%
• Sale/Leaseback Debt Service	84	100+%

Fiscal Policy Goals

- ❑ Eliminate structural shortfall
- ❑ Develop multi-year solution with targets - Reduce reliance on 1-time solutions over time
- ❑ Long term goal: set aside 1-time revenues
 - Excess ending balances
 - Excess capital gains
- ❑ Dedicate 1-time \$ for 1-time purposes
 - Rebates
 - Operating debt buyback - \$84 M annual debt payment
 - Infrastructure
 - IT Modernization

California Just Approved Ballot Initiative to Address Volatility

- ❑ 1.5% of annual General Fund revenue will be deposited into Rainy Day Fund
- ❑ Excess capital gains income tax collections will be deposited into the fund as well
- ❑ 50% of fund will be used to buy down state debts, including unfunded retirement and operating loans
- ❑ Rainy Day Fund capped at 10% of GF revenue; excess dedicated to infrastructure
- ❑ Emergency provisions allow deposit requirements to be suspended

Appendix A: October 2014 4-Sector Forecast

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
Sales Tax				
JLBC Forecast	4.1%	4.5%	4.8%	5.0%
UA – Low	2.8%	3.1%	5.2%	6.2%
UA – Base	5.0%	6.1%	7.3%	7.2%
FAC	4.1%	4.1%	4.9%	4.7%
Average:	4.0%	4.5%	5.6%	5.8%
Individual Income Tax				
JLBC Forecast	4.5%	5.4%	5.0%	5.0%
UA – Low	1.2%	2.9%	4.9%	6.2%
UA – Base	3.7%	5.6%	6.3%	7.0%
FAC	3.4%	4.5%	4.6%	4.6%
Average:	3.2%	4.6%	5.2%	5.7%
Corporate Income Tax				
JLBC Forecast	(3.3)%	1.0%	3.5%	4.5%
UA – Low	(1.0)%	(0.2)%	(6.3)%	(10.2)%
UA – Base	1.6%	6.0%	0.1%	(7.4)%
FAC	(10.3)%	(5.9)%	6.3%	6.5%
Average:	(3.2)%	0.4%	0.6%	(2.0)%
JLBC Weighted Average	3.7%	4.7%	4.8%	5.0%
UA Low Weighted Average	1.8%	2.8%	4.5%	5.7%
UA Base Weighted Average	4.2%	5.9%	6.5%	6.5%
FAC Consensus Weighted Average	2.8%	3.7%	4.8%	4.7%
“Big-3” Weighted Average	3.1%	4.3%	5.2%	5.4%
Consensus Weighted Average*	3.4%	4.1%	5.1%	5.2%
Adjusted Consensus Weighted Average**	2.2%	3.0%	4.4%	4.6%
* Adjusted for small revenue categories				
** Adjusted for tax law changes				

