JLBC Staff – April 2015 Revenue and Budget Update

Summary of the General Fund Budget Outlook

- The Legislature enacted a FY 2016 budget in early March. The $9.1 billion General Fund spending plan had a projected FY 2016 ending cash balance of $450,000. One-time monies were used to offset a $(257) million structural shortfall (difference between ongoing revenues and spending).
- Under the budget's 3-year planning projections, the structural shortfall is eliminated in FY 2018.
- The April Update reflects an updated 4-sector revenue forecast as well as the fiscal impact of legislation adopted outside of the budget package. As of this writing, the Governor has not yet acted on all pending legislation.
- In terms of a base revenue growth rate, the new April forecast is more optimistic than the January Baseline in FY 2015 and FY 2016, but more cautious in FY 2017 and FY 2018.
- The actual FY 2015 results, however, especially have the potential to be greater than even the new April forecast. A contributing factor is the phase-in of the corporate income tax reductions, which may be slower than expected.
- The April Update results in small changes to the March Plan's ending balance estimates, but does not change the overall direction of the enacted budget. *See Table 1*.
- The projected FY 2016 ending balance would be $33 million under the April Update. If the tax conformity bill is signed into law, the balance would be revised down to $3 million. [1/]

A slideshow presentation of the April FAC Update can be found at the JLBC website. The April FAC Meeting link contains other panelists' presentations and background materials.

Table 1

Ending Balance Projections

	$ in M			
	'15	**'16**	**'17**	**'18**
Enacted Budget	$12	$0	$(16)	$33
Adjusted for April FAC	12	33	(15)	12
Adjusted for April FAC + Conformity	12	3	(46)	(18)
April FAC + Conformity + K-12 Reset	12	(260)	(313)	(290)

Forecast Risks

The April Update is associated with a number of forecast risks that could increase or reduce the projected budget balances. Even small changes can have significant impacts on the budget as a 1% forecast error over 3 years would revise the ending balance by $575 million.

Potential Gains

- The national economic recovery could have positive impacts for Arizona, especially in generating more migration from other states. To some extent, the higher April forecast for FY 2015 and FY 2016 has begun reflecting the improved national fortunes.

1/ 4/10 Note: Tax Conformity was subsequently signed into law.

- A sustained drop in gasoline prices could spur greater consumer retail activity. As of yet, however, surveys suggest that consumers have not yet converted their gas savings into substantial new purchases.
- The full impact of previously enacted corporate income tax (CIT) reductions may not begin in FY 2015 as originally anticipated, thereby resulting in higher General Fund revenue.

Potential Gain or Loss

- The 2013 Legislature enacted significant changes in the state's Transaction Privilege Tax (TPT) statutes. As of January 2015, the legislation shifts taxation of some materials from the contracting to the retail classification. While that particular provision may result in lower collections, the legislation had other offsetting revenue increases. The bill was originally scored as revenue neutral, but TPT collections will need to be monitored closely for signs of a potential windfall or loss.

Potential Losses

- The projected improvement in the national economy could be derailed by a number of factors, including the timing of the Federal Reserve Board's changes in its monetary policy as well as the uncertainty of international events.
- Pending litigation could also increase costs beyond the FY 2016 appropriation level. For example, the state has not yet resolved the K-12 inflation lawsuit. If the Maricopa Superior Court ruling is upheld, the state's slight cash balances would become clearly negative.
- The Governor has not yet taken action on a bill to conform the state's business expensing, otherwise known as "instant depreciation," to the $500,000 level, as permitted by the federal government. The conformity legislation would have a cost of $31 million relative to the Baseline.

April 4-Sector Forecast Update

The 4-sector forecast consists of contributions from each of the following:

- Finance Advisory Committee panelists
- University of Arizona (UA) base econometric model
- UA low econometric model
- JLBC Staff

Each sector is equally weighted for each of the largest General Fund revenue categories: TPT, Individual Income Tax (IIT) and Corporate Income Tax. *See Attachment A.* The JLBC Staff provides the projection for smaller tax and revenue categories.

FY 2015

The January 4-sector projected FY 2015 base revenue growth of 4.3%. Base revenue reflects the underlying change in state revenue prior to the application of tax law changes, one-time adjustments and urban revenue sharing. The 4-sector April forecast increases that projected growth to 4.8%.

In comparison, preliminary year-to-date (YTD) General Fund revenue through March is 4.9% above FY 2014 and $87 million above the enacted budget forecast. March YTD growth is difficult to evaluate, however, as it is in the middle of income tax filing season. Given the level of payments and refunds, slight shifts in the timing of receipts and disbursements from one year to the next can have a substantial impact on the YTD estimate.

While an increase in FY 2015 projected revenue growth would normally increase the ending balance, this year's budget has a provision that may eliminate that impact. Laws 2015, Chapter 8 requires sufficient monies to be transferred from the Budget Stabilization Fund (BSF), otherwise known as the Rainy Day Fund, to generate a $12 million FY 2015 General Fund ending balance.

At the time of the budget's enactment, the projected FY 2015 BSF transfer was $113 million. With the higher projected 4.8% growth rate, the transfer amount would decline to $70 million. As described in further detail below, several other factors could further influence the BSF transfer level.

FY 2016 and Beyond

The January 4-sector forecast included a 3.3% base revenue growth rate for FY 2016. Based on general improvements in the economy, the April estimate raises the projected growth to 3.7%. The March enacted budget had increased the projected revenue growth to 3.8%, or 0.1% higher than the April update.

Given the 4.8% forecasted growth rate in FY 2015, the 3.7% April estimate would seem to suggest a slowing of the economy next year. Upon closer examination, the FY 2016 growth rates of 3 of the 4 sectors are comparable to the FY 2015 consensus. The FAC, JLBC Staff and UA-Base all forecast either 4.6% or 4.7% growth in FY 2016. The UA-Low, however, has a projected growth of only 1.2%. This scenario reflects a "stalled recovery" which is hampered by continued weak household formation. Global Insight, an international economics consulting firm, places the odds of such an outcome at 15%.

While FY 2015 and FY 2016 growth rates improved in April, the FY 2017 and FY 2018 forecasts were not as optimistic *(see Table 2)*. The FY 2017 rate declined from 4.4% in January to 4.1% now, while FY 2018 was reduced from 5.1% to 4.8%. In general, the lower outyear projections reflect the potential of higher interest rates and a tighter job market to moderate economic growth.

Table 2

Base Revenue Percentage Growth Rates

4-Sector	'15	'16	'17	'18
January*	4.3	3.3	4.4	5.1
April	4.8	3.7	4.1	4.8

* The March Budget used the January estimates, but adjusted the FY 2016 rate from 3.3% to 3.8%

Net General Fund Revenue Impact

The net overall change in General Fund revenues is a combination of base revenue changes along with statutory changes. The latter include changes enacted in prior years as well as during the 2015 Legislative Session. The Governor has yet to take action on some revenue legislation, so these estimates are subject to further change.

Under the April Update, FY 2016 net General Fund revenues are predicted to increase by $377 million, or 4.3%. These estimates exclude the net loss of the $565 million associated with the beginning balance. If the balance were included, the net General Fund revenue change would be (2.0)%. The corresponding net revenue growth in FY 2017 and FY 2018 is $122 million and $259 million, respectively.

As described in *Table 3*, the 4.3% net growth consists of numerous adjustments.

Table 3

Net FY 2016 Revenue Growth

	$ in M
3.7% Base Revenue	$344
Pre-2015 Enacted Tax Legislation*	(112)
2015 Newly-Enacted Revenue*	61
New Fund Transfers	205
Elimination of FY 2015 Transfers	(54)
Elimination of FY 2015 Budget Stabilization Transfer	(70)
Urban Revenue Sharing	3
	$377

* *See Attachment C for details.*

Three particular issues could affect the net revenue and ending balance projections: a) the timing of CIT reductions, b) the 2013 TPT simplification legislation, and c) the 2015 Internal Revenue Service Conformity bill.

The Timing of Corporate Income Tax Reductions

In 2011, the Legislature approved 2 significant CIT changes as of January 2014:

- The CIT rate would decline over 4 years from approximately 7.0% to 4.9%, and
- The sales factor would increase over 4 years from 80% to 100%. When fully phased in, this adjustment allows a multi-state company to use its Arizona sales relative to other states, as opposed to its personnel and property holdings, in determining CIT liability.

The 4-year phase-in started with tax year (TY) 2014. A business may begin its tax year any time between January and December. If a company has a January – December 2014 tax year, for example, its TY 2014 state taxes are due in April 2015. The JLBC Staff methodology has been to assume that the first year of the 4-year phase-in would fully occur in FY 2015.

Based on further research and discussions with the Department of Revenue (DOR), however, a majority of the first year impact of the phase-in may not occur until FY 2016. Most large corporations receive a 6-month extension to file their returns. As a result, their TY 2014 returns are not filed until October 2015 (FY 2016). To avoid a penalty, corporations must either have made estimated payments equal to their prior year liability or 90% of their current year liability.

While a corporation would reduce its tax bill more quickly if it filed in April than in October, the state tax filing may be largely driven by the much larger federal liability. If there is no incentive to file a federal return sooner, the state may not feel the impact of TY 2014 CIT reductions until October 2015 (FY 2016).

The magnitude of this potential shift cannot be determined in advance with any certainty. As a result, the April Update continues to assume that the full first year impact of $70 million would occur this spring. It is likely, however, that the FY 2015 reduction will not be this great.

Due to the interaction with the BSF transfer, however, there may be no impact on the statutorily-required $12 million ending balance.

TPT Simplification

The implementation of the 2013 "TPT Simplification" legislation may also affect the budgeted revenue estimates. Under this legislation, service contractors that do work related to maintenance, repair or replacement of existing property are exempt from the prime contracting tax, beginning January 1, 2015. Instead, such contractors are now required to pay the retail transaction privilege tax on materials that they purchase as a part of the service contract.

In 2013, the JLBC Staff estimated that the shift of the tax base for this type of contracting activity would result in revenue loss for the General Fund. However, the 2013 legislation included other provisions that were intended to keep the bill as a whole revenue neutral.

January TPT contracting collections declined by (17.4)% from prior year, the largest such decline since August 2010. Retail collections for the same month increased by 8.9%, although some of the growth was likely related to the Super Bowl. This suggests that the change of the tax base could make the collections of these 2 TPT categories more volatile in the 2015 transition year. While it is difficult to measure the bill's impact as it relates to all its various provisions, the monitoring of contracting and retail sales will be important in the coming months.

Tax Conformity

As noted previously, the April Update does not include the potential $(31) million impact of a provision in SB 1188 that conforms the state business expensing allowance to the $500,000 federal amount. While the permanent federal level is only $25,000, Congress has been annually authorizing an increase in the allowance to $500,000. Business expensing permits a company to deduct the full value of equipment up to $500,000 from their taxable income in the tax year the equipment was purchased.

The state previously conformed to the enhanced federal amount in 2013. In 2014, Governor Brewer vetoed a bill that would have made the $500,000 allowance permanent. The resulting savings were subsequently used to fund the newly established Department of Child Safety. As a result of the veto's redirection of these monies, the January Baseline excluded funding for the enhanced allowance. If the Governor signs SB 1188 and once again conforms the state to the $500,000 federal deduction, the bill would reduce the April revenue estimates by $(31) million beginning in FY 2015.

Ending Balance Projections

As enacted in March, the budget was projected to have a $12 million balance at the end of FY 2015 in line with the automatic transfer requirements from the Budget Stabilization Fund. Given that provision, the April Update does not change the projected FY 2015 balance estimate.

The March budget had a projected FY 2016 ending balance of $450,000. The improvement in the short term revenue forecast increases that estimate to $33 million. If the Governor were to sign the IRS conformity bill, the balance would be closer to $3 million.

In its associated 3-year spending plan, the March budget had a FY 2017 shortfall of $(16) million. The April Update leaves that estimate virtually unchanged at a $(15) million shortfall. Conformity would increase the shortfall to $(46) million.

March's 3-year plan would produce a $33 million cash balance in FY 2018. This amount also reflects a structural balance of the same amount, which reflects ongoing revenue less ongoing spending. On its own, the April Update reduces the balance to $12 million. The pending tax legislation would then reduce that amount to a $(18) million shortfall.

While either the March budget or the April Update result in ending balance estimates near $0 through FY 2018, the state's K-12 litigation could potentially result in more noticeable deficits. In July 2014, the Maricopa Superior Court ruled that the state must "reset" the K-12 per pupil formula amount to adjust for inflation funding that was not provided during FY 2009-FY 2013. This "reset" would translate into increased K-12 spending of $337 million in FY 2016. The March budget did provide $74 million in "extra" per pupil funding over and above normal inflation. If this $74 million is counted toward the reset, the revised cost would be $262 million.

The plaintiffs and the state have been in discussions to resolve the litigation. If the original Maricopa Superior Court ruling were ultimately upheld, the April Update's FY 2016 balance of $3 million (with IRS conformity) would become a $(260) million shortfall.

The April Update Statement of Revenues and Expenditures appears in *Attachment B*.

April 9, 2015 FAC 4-Sector Consensus

	FY 2015	FY 2016	FY 2017	FY 2018
Sales Tax				
JLBC Forecast (3/20/2015)	4.3%	4.5%	4.8%	5.0%
UA - Low (3/20/2015)	3.7%	1.1%	2.2%	4.6%
UA - Base (3/20/2015)	4.3%	4.6%	5.2%	5.9%
FAC (3/20/2015)	4.3%	4.6%	4.9%	4.8%
Average:	**4.2%**	**3.7%**	**4.3%**	**5.4%**
Individual Income Tax				
JLBC Forecast (3/20/2015)	5.4%	5.2%	5.3%	5.3%
UA - Low (3/20/2015)	2.9%	1.5%	2.6%	4.3%
UA - Base (3/20/2015)	3.7%	4.4%	4.8%	5.5%
FAC (3/20/2015)	5.2%	5.0%	5.1%	5.4%
Average:	**4.3%**	**4.0%**	**4.5%**	**5.1%**
Corporate Income Tax				
JLBC Forecast (3/20/2015)	15.0%	1.2%	3.1%	3.9%
UA - Low (3/20/2015)	11.2%	0.1%	-9.1%	-14.2%
UA - Base (3/20/2015)	11.2%	5.5%	-0.8%	-9.2%
FAC (3/20/2015)	9.8%	3.3%	6.0%	6.4%
Average:	**11.8%**	**2.5%**	**-0.1%**	**-2.7%**
JLBC Weighted Average:	**5.5%**	**4.6%**	**4.9%**	**5.1%**
UA Low Weighted Average:	**3.9%**	**1.2%**	**1.8%**	**4.0%**
UA Base Weighted Average:	**4.5%**	**4.6%**	**4.7%**	**5.3%**
FAC Consensus Weighted Average:	**5.1%**	**4.7%**	**5.0%**	**5.4%**
"Big-3" Weighted Average:	**4.8%**	**3.8%**	**4.1%**	**4.9%**
Consensus Weighted Average: *	**4.8%**	**3.7%**	**4.1%**	**4.8%**
Adj. Consensus Weighted Average: **	**3.6%**	**3.0%**	**2.9%**	**3.8%**

* Consensus Big-3 Categories adjusted for Small Categories

** Consensus Weighted Average adjusted for Statutory Changes

April FAC
Statement of General Fund Revenues and Expenditures 1/
with One-Time Financing Sources

	FY 2015 April FAC	FY 2016 April FAC	FY 2017 April FAC	FY 2018 April FAC
REVENUES				
Ongoing Revenues	$9,229,177,400	$9,582,733,000	$9,905,937,500	$10,269,149,800
Previously Enacted Changes		(111,500,000)	(86,900,000)	(84,200,000)
Newly Enacted Changes	11,000,000	46,433,200	(24,116,600)	(21,800,000)
Urban Revenue Sharing	(608,935,700)	(605,634,300)	(625,583,100)	(635,007,500)
Net On-going Revenues	$8,631,241,700	$8,912,031,900	$9,169,337,800	$9,528,142,300
One-time Financing Sources				
Balance Forward	577,399,200	12,000,000		
Rainy Day Fund Transfer	69,738,700			
Tax Amnesty		15,000,000		
Fund Transfers	68,900,000	220,194,500	100,000,000	
Subtotal One-time Revenues	$716,037,900	$247,194,500	$100,000,000	$0
Total Revenues	$9,347,279,600	$9,159,226,400	$9,269,337,800	$9,528,142,300
EXPENDITURES				
Operating Budget Appropriations	$9,321,780,500	$9,161,035,300	$9,323,310,600	$9,561,694,500
Supplementals	(28,132,000)			
Administrative Adjustments	80,000,000	70,000,000	70,000,000	70,000,000
Revertments	(80,000,000)	(111,380,700)	(109,128,200)	(116,014,500)
Subtotal Ongoing Expenditures	$9,293,648,500	$9,119,654,600	$9,284,182,400	$9,515,680,000
One-time Expenditures				
Capital Outlay	$41,631,100	$6,200,000		
Subtotal One-time Expenditures	$41,631,100	$6,200,000	$0	$0
Total Expenditures	$9,335,279,600	$9,125,854,600	$9,284,182,400	$9,515,680,000
Ending Balance 2/	$12,000,000	$33,371,800	($14,844,600)	$12,462,300
Structural Balance 3/	*($662,406,800)*	*($207,622,700)*	*($114,844,600)*	*$12,462,300*
Ending Balance (w/ K-12 Litigation) 4/	N/A	($228,914,600)	($281,844,500)	($259,317,100)
Structural Balance (w/ K-12 Litigation) 3/	N/A	($469,909,100)	($381,844,500)	($259,317,100)

1/ Significant one-time revenues and expenditures are separately detailed so as to permit the calculation of ongoing revenue and expenditures.

2/ This calculation reflects the difference between total revenues and total expenditures. Excludes any Budget Stabilization Fund balance.

3/ This calculation reflects the difference between ongoing revenues and expenditures and excludes one-time adjustments. Excludes any Budget Stabilization Fund balance.

4/ Expenditures include the impact of the Maricopa County Superior Court ruling in the K-12 litigation which would require the state to "reset" the per pupil amount prospectively to adjust for foregone inflation in prior years. Estimate assumes $74 million in "extra" base support in the FY 2016 budget is applied to the reset cost. Expenditures do not include "back payments" for K-12 inflation payments which did not occur in prior years, as the Superior Court has not issued a ruling on this matter. Ending balance estimates do not include any Budget Stabilization Fund balance.

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Marginal Dollar Impact of Previously Enacted Tax Law Changes [1/]

($ in millions)

Legislation	FY 2015	FY 2016	FY 2017	FY 2018
Laws 2006, Chapters 14 & 325				
School Tuition Credit for Low-Income Students	(7.2)	(8.6)	(10.3)	(12.4)
Laws 2011, 2nd Special Session, Chapter 1 ("Jobs Bill 1")				
Increases small businesses eligibility for 30% "Angel" investment credit from $2m to $10m in assets	(0.5)	4.5	0.0	0.0
Eliminates capital gains on income derived from small businesses, beginning in TY 2014	(8.6)	0.0	0.0	0.0
Phases down corporate tax rate from 6.968% to 4.9% over 4 years, beginning in TY 2014	(41.3)	(41.7)	(37.5)	(39.9)
Phases in corporate sales factor from 80% to 100% over 4 years, beginning in TY 2014	(28.5)	(26.1)	(22.7)	(18.6)
Creates annual $3,000 3-year new job credit with conditions	(4.2)	(4.2)	(3.1)	0.0
Sub-Total	**(83.1)**	**(67.5)**	**(63.3)**	**(58.5)**
Laws 2012, Chapter 343 ("Jobs Bill 2")				
Phases in (over 3 years) a 25% reduction of long-term capital gains on assets purchased after CY 2011 (TY 2013)	(9.2)	(11.3)	0.0	0.0
Provides income tax deduction equal to 10% of federal bonus depreciation for assets placed in service in CY 2012 (TY 2014 only)	(1.8)	0.0	0.0	0.0
Creates a new income tax credit for capital investments in new or expanded manufacturing facilities, commercial headquarters, or research facilities (TY 2013)	(4.0)	(4.0)	(4.0)	(4.0)
Sub-Total	**(15.0)**	**(15.3)**	**(4.0)**	**(4.0)**
Laws 2012, Chapter 2				
Provides a change in the calculation of the corporate sales factor for service-providers (TY 2014)	(3.0)	0.0	0.0	0.0
Laws 2013, 1st Special Session, Chapter 9				
Exempts data center equipment from TPT (Sep. 1, 2013)	(1.8)	(1.9)	0.0	0.0
Laws 2014, Chapter 7				
Exempts electricity and natural gas purchased by manufacturers from TPT (Aug. 1, 2014)	(14.6)	(3.6)	0.0	0.0
Laws 2014, Chapter 8				
Credit for investment in new facilities that produce energy for self-consumption using renewable energy sources (Jul. 24, 2014)	0.0	(10.0)	0.0	0.0
Laws 2014, Chapter 10 & Laws 2015, Chapter 91				
Inflation indexing of individual income tax rate brackets, beginning in TY 2015	0.0	(6.1)	(9.3)	(9.3)
Laws 2014, Chapter 11				
Unexpended capitation payments in the Long-Term Care System Fund are reverted to the General Fund	7.9	0.0	0.0	0.0

Legislation	FY 2015	FY 2016	FY 2017	FY 2018
Laws 2014, Chapter 68				
Requires individual income tax-filers claiming the Proposition 301 low-income sales tax credit to provide a valid SSN (Jan. 1, 2015)	0.0	1.5	0.0	0.0
Laws 2014, Chapter 127				
Shifts fine revenues for operating watercraft while intoxicated from the General Fund to Other Fund (Jul. 24, 2014)	(0.5)	0.0	0.0	0.0
Laws 2014, Chapter 168				
Employer allowed to claim 2nd and 3rd year job tax credits for employees that leave and are replaced within 90 days (Jan. 1, 2014)	(0.9)	0.0	0.0	0.0
Laws 2014, Chapter 228				
Exempts the construction of mixed waste processing facility located on a municipal landfill from TPT (Jan. 1, 2013)	(0.2)	0.0	0.0	0.0
Laws 2014, Chapter 276				
Exempts personal property sold to a qualified health sciences educational institution from TPT (Jan. 1, 2015)	(0.2)	0.0	0.0	0.0
Total GF Revenue Impact of Previously Enacted Legislation over Prior Year	**(118.6)**	**(111.5)**	**(86.9)**	**(84.2)**

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Marginal Dollar Impact of Newly Enacted Tax Law Changes [1/]

($ in millions)

Legislation	FY 2015	FY 2016	FY 2017	FY 2018
Laws 2015, Chapter 6				
Exempts International Operations Centers from TPT on Electricity Purchases	0.0	0.0	(1.3)	0.0
Laws 2015, Chapter 8				
Department of Revenue - Fraud Detection and Prevention	0.0	41.9	(13.6)	(13.0)
Laws 2015, Chapter 10				
Department of Insurance - Fraud Assessment	0.0	0.5	0.0	0.0
Laws 2015, Chapter 10				
Establishes a Tax Amnesty Program	0.0	15.0	(15.0)	0.0
Laws 2015, Chapter 14				
Increases Disproportionate Share Cap	11.0	5.5	(7.9)	(8.6)
Laws 2015, Chapter 184				
Exempts Retaliatory Insurance Premium Taxes	0.0	(1.5)	0.0	0.0
Laws 2015, Chapter 220				
Phases Down Insurance Premium Tax Rate from 2.0% to 1.7% over 11 Years	0.0	0.0	(1.3)	(0.2)
Total GF Revenue Impact of Recently Enacted Legislation over Prior Year	**11.0**	**61.4**	**(39.1)**	**(21.8)**
Ongoing Impact	**11.0**	**46.4**	**(24.1)**	**(21.8)**
One-Time Impact	**0.0**	**15.0**	**(15.0)**	**0.0**

1/ Each year represents the dollar value of the provision compared to the prior year.