

HIGHLIGHTS OF THE FY 2006 BUDGET

The First Regular Session of the 47th Legislature convened in January 2005. By May, the Legislature had enacted a Fiscal Year (FY) 2006 budget for the year beginning July 1, 2005. A FY 2007 Budget was also approved for small General Fund and most Other Fund agencies.

The state's FY 2006 General Fund budget is \$8.21 billion. After accounting for non-General monies, the state's "all funds" budget is \$23.7 billion. *See page BD-7 for information on appropriated fund spending and page BD-14 for total funds spending by agency.*

Revised FY 2005 Budget – The FY 2005 budget did not require adjustments to resolve mid-year shortfalls. At the time of the publication of the *FY 2005 Appropriations Report* in July 2004, the projected FY 2005 General Fund ending balance was \$2.4 million. By the time the First Regular Session adjourned, the projected ending balance was \$329.4 million. This higher ending balance was due to a \$632.3 million increase in projected revenues offset by \$305.3 million in net spending increases. *See page 458 for further details on these FY 2005 changes.*

The higher revenues resulted from stronger than expected economic conditions. While the budget assumed a FY 2005 General Fund base revenue growth rate of 8.4% when enacted in May 2004, the revised budgeted growth rate is 13.3%. The higher FY 2005 spending was due primarily to \$252.5 million in conditional, or "triggered" appropriations. The enacted budget dedicated General Fund revenues above forecast to certain purposes. Of the \$252.5 million, the Budget Stabilization Fund received \$156.5 million.

Since the passage of the budget in May, General Fund revenue growth has exceeded the forecast for the remaining months of FY 2005 by approximately \$250 million. As a result, the FY 2005 ending cash balance is likely to be closer to \$580 million than \$329 million, as budgeted.

The FY 2006 Statutory and Funding Formula Shortfall – At the beginning of the First Regular Session, the JLBC Staff calculated the growth in the state's anticipated FY 2006 General Fund spending based on existing statutory funding formulas and other technical requirements. These spending estimates included \$300 million to convert the state's K-12 school construction program from debt to cash financing and a \$189 million deposit to the state's Budget Stabilization Fund (BSF). The projected spending level was \$8.36 billion. Based on 7.2% revenue growth, General Fund revenues were anticipated to be \$7.88 billion. These assumptions resulted in a projected FY 2006 shortfall of \$(477) million at the beginning of session.

The final FY 2006 budget reduces the JLBC spending level by \$(147) million. The final budget spends less than the JLBC budget in 3 key areas: 1) There is no \$189 million BSF deposit. (As described below, monies will be added if FY 2006 General Fund revenues exceed the forecast). 2) Of the \$300 million school construction cost, \$50 million is moved to FY 2007. 3) The estimate of unexpended FY 2005 appropriations ("revertments") has increased by \$47 million.

With \$(286) million in reductions to the JLBC spending level, all other spending has increased above the JLBC budget by \$139 million (for a net reduction of \$147 million). The main adjustments are as follows:

- \$45 million for a higher than required K-12 inflation adjustment of 3.2%;
- \$43 million for state employee pay adjustments; and
- \$21 million to compensate Maricopa County for cost shifts in the FY 2004 and 2005 budgets. The JLBC budget had already eliminated non-Maricopa shifts.

After adjusting for the lower spending, the final budget resolved the original JLBC shortfall with both permanent and one-time revenue adjustments:

	<u>\$ in Millions</u>
• Lower Spending	\$147
• Higher Revenue Estimate	174
• Higher FY 2005 Surplus	188
• Fund Transfers	16
• Tax Reductions	<u>(18)</u>
Total	\$507

Comparison to the FY 2005 Budget – General Fund revenues, including one-time monies, are projected to increase from \$7.99 billion in FY 2005 to \$8.25 billion in FY 2006. Of the overall \$256 million net increase in revenues, \$508 million is from permanent revenues. This adjustment reflects a 7.4% increase in permanent base revenues. *See page 379 for more details on the revenue adjustments.* The permanent revenues were offset by a \$252 million decline in one-time monies, primarily due to a reduction in the use of fund transfers.

General Fund spending is projected to grow by 7.2% from \$7.66 billion in FY 2005 to \$8.21 billion in FY 2006. This net change of \$553 million includes an increase of \$888 million in permanent spending and a reduction of \$(335) million in one-time spending. Excluding the one-time adjustments, permanent spending is expected to increase 12.2% in FY 2006.

The primary permanent spending increases are \$276 million for the School Facilities Board (SFB), \$159 million for the Department of Education, \$121 million for AHCCCS and \$88 million for the Department of Health Services. The one-time adjustments include a \$(102)

million decline in SFB, primarily related to the Deficiencies Corrections repair program of older schools, a \$(76) million reduction in the Ladewig lawsuit payments and elimination of the \$156 million FY 2005 BSF deposit. See the Budget Units section for information on individual agency budgets.

Tax Reductions – The Legislature enacted significant long term tax reductions for the first time since 1999. While the FY 2006 impact is only \$18 million, the dollar value of the tax reductions will grow over time. The main elements of the tax package (see page 381) include:

- Ending the marriage penalty on certain tax credits, an inflation adjustment in the income tax standard deduction and conformity with the federal Internal Revenue code. These changes represent essentially all of the \$18 million in FY 2006 tax reductions.
- A 10-year phase-in of a reduction in business property taxes, which will ultimately cost \$140 million.
- Beginning in tax year 2007, a revision in the formula for corporate income tax liability to allow a greater reliance on in-state sales. The direct full impact by FY 2011 is forecast to be \$120 million. This estimate does not include potential offsetting tax receipts to the extent that a lower corporate income tax stimulates greater general economic activity.

“Triggers” – The enacted budget provides conditional appropriations if excess General Fund revenues materialize during FY 2006. All excess revenues would be deposited into the Budget Stabilization Fund.

Structural Balance – The structural balance is the difference between permanent revenues and permanent spending. The state can have a balanced budget, but a structural shortfall, if it uses one-time revenues and/or one-time spending reductions in its budget plan.

Under the enacted budget, the state’s structural FY 2005 surplus is \$122 million. If adjusted for the use of debt

financing of school construction, this estimate would become a \$(128) million shortfall. The enacted FY 2006 budget has a structural shortfall of \$(258) million.

As noted above, year-end FY 2005 General Fund revenues are running approximately \$250 million above forecast. If these excess revenues ultimately prove to be permanent and not one-time, the FY 2006 structural shortfall would essentially be eliminated.

FY 2006 Ending Balance – As opposed to the structural shortfall, the enacted budget’s FY 2006 ending cash balance is \$31.5 million. With the higher than budgeted FY 2005 carry-forward, this balance could become \$280 million by the end of FY 2006. This balance will be used in the FY 2007 budget to replace the \$345 million in one-time monies used to balance the FY 2006 budget.

Vetoes – The Legislature initially approved an entire package of budget legislation on March 18, 2005. The Governor vetoed this entire budget with the exception of a FY 2005 supplemental bill. This budget had a spending level of \$8.18 billion, compared to the final budget of \$8.21 billion. *The General Fund Statement on BH-4 and the Detail List on page 410 provides more detail on this budget.*

The enacted budget included vetoes of the following provisions:

- Deposit of FY 2005 General Fund revenues above the forecast to the BSF;
- Elimination of a General Fund transfer to the Arizona Sports and Tourism Authority;
- Deposit of unrestricted federal funds to the General Fund;
- Changes in the School Facilities Board’s Building Renewal Formula; and
- Creation of a corporate income tax credit for school scholarships.

STATEMENT OF GENERAL FUND REVENUES AND EXPENDITURES

	FY 2005 Estimate	FY 2006 Approved
REVENUES		
On-going Revenues	7,392,166,900	7,900,319,800
One-time Revenues, including Balance Forward	598,123,400	345,359,100
Total Revenues	\$7,990,290,300	\$8,245,678,900
EXPENDITURES		
Operating Budget Appropriations	7,470,282,000	8,191,894,400
Capital	0	17,150,000
Budget Stabilization Fund Deposit	156,490,500	0
Ladewig Litigation Allocation	134,300,000	58,300,000
Federal Fund Maximization Revertments	(25,000,000)	(25,000,000)
Administrative Adjustments	23,000,000	23,000,000
Revertments	(98,169,300)	(51,169,300)
Total Spending	\$7,660,903,200	\$8,214,175,100
ENDING BALANCE	\$329,387,100	\$31,503,800

**STATEMENT OF GENERAL FUND REVENUES AND EXPENDITURES 1/2/
WITH ONE-TIME FINANCING SOURCES**

	Mar 18 Budget FY 2005	Enacted Budget FY 2005	Mar 18 Budget FY 2006	Enacted Budget FY 2006
	<u>3/</u> House-Senate		<u>3/</u> House-Senate	
REVENUES				
On-going Revenues	\$7,720,183,500	\$7,765,241,100	\$8,290,036,700	\$8,337,236,700
Revenue Adjustments	0	0	0	6,362,000
Tax Law Changes	0	0	(25,000,000)	(18,050,000)
Urban Revenue Sharing	(\$373,074,200)	(\$373,074,200)	(425,228,900)	(425,228,900)
Revised On-going Revenues	<u>7,347,109,300</u>	<u>7,392,166,900</u>	<u>7,839,807,800</u>	<u>7,900,319,800</u>
One-time Revenues				
Balance Forward	360,000,000	360,388,900	269,046,300	329,387,100
Prior Fund Transfers	43,734,500	43,734,500	0	0
New FY 2006 Fund Transfers	0	0	78,972,000	15,972,000
Vehicle License Tax Transfer	118,000,000	118,000,000	0	0
Income Tax Withholding Adjustment	76,000,000	76,000,000	0	0
Subtotal One-time Revenues	<u>597,734,500</u>	<u>598,123,400</u>	<u>348,018,300</u>	<u>345,359,100</u>
Total Revenues <u>4/</u>	\$7,944,843,800	\$7,990,290,300	\$8,187,826,100	\$8,245,678,900
EXPENDITURES				
Operating Budget Appropriations	7,285,121,200	7,285,226,900	8,161,530,900	8,193,899,500
FY 05 Supplementals	83,055,100	85,055,100	0	0
Capital Outlay	0	0	15,150,000	17,150,000
Maximizing Federal Fund Savings <u>5/</u>	(25,000,000)	(25,000,000)	(25,000,000)	(25,000,000)
Administrative Adjustments	23,000,000	23,000,000	23,000,000	23,000,000
Revertments	(81,169,300)	(98,169,300)	(51,169,300)	(51,169,300)
Subtotal Permanent Expenditures	<u>7,285,007,000</u>	<u>7,270,112,700</u>	<u>8,123,511,600</u>	<u>8,157,880,200</u>
One-time Expenditures				
SFB Deficiencies Corrections	100,000,000	100,000,000	20,000,000	20,000,000
SFB Payment Holiday	0	0	(22,005,100)	(22,005,100)
Ladewig Litigation Payments	134,300,000	134,300,000	58,300,000	58,300,000
Budget Stabilization Fund Deposits <u>6/</u>	156,490,500	156,490,500	0	0
Subtotal One-time Expenditures	<u>390,790,500</u>	<u>390,790,500</u>	<u>56,294,900</u>	<u>56,294,900</u>
Total Spending	\$7,675,797,500	\$7,660,903,200	\$8,179,806,500	\$8,214,175,100
ENDING BALANCE	\$269,046,300	\$329,387,100	\$8,019,600	\$31,503,800
Structural Balance <u>7/8/</u>	\$62,102,300	\$122,054,200	(\$283,703,800)	(\$257,560,400)

1/ This statement reflects the summary statement used to brief legislators during the course of the session. Significant one-time revenues and expenditures have been separately detailed so as to permit the calculation of the structural shortfall.

2/ Reflects status at the adjournment of the 1st Regular Session. The enacted budget includes provisions for conditional "triggered" appropriations to the Budget Stabilization Fund if revenues exceed the forecast for FY 2006. This statement does not reflect any of these "triggered" appropriations.

3/ Reflects March 18 Legislative budget that was vetoed.

4/ Details on revenues can be found in the Economic and Revenue Forecast section.

5/ Savings related to maximizing the use of Federal Funds. Savings will take the form of a revertment of appropriated funds.

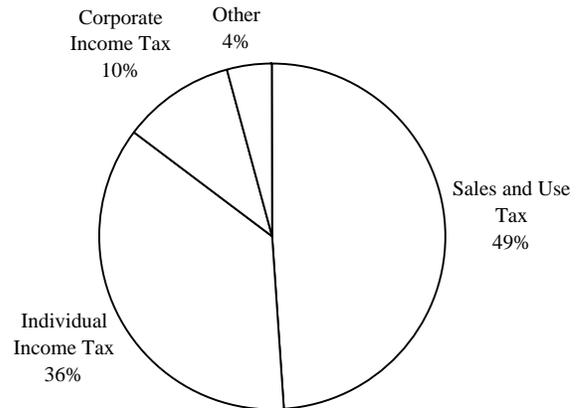
6/ The enacted budget deposits FY 2006 revenues above forecast into the Budget Stabilization Fund.

7/ The structural balance in this calculation reflects the difference between permanent on-going revenues and permanent expenditures. A negative number represents a shortfall.

8/ If K-12 construction cash expenses were included, the FY 2005 shortfall would have been \$(188) million in the March 18 House-Senate budget proposal and \$(128) million in the enacted budget proposal. The FY 2006 estimates already include construction cash expenses.

FY 2006 General Fund Revenue - Where it Comes From ^{1/}

<u>Source</u>	<u>Revenue (Millions)</u>
Sales and Use Tax	\$ 3,865.8
Individual Income Tax	2,874.9
Corporate Income Tax	820.2
Other	339.4
TOTAL REVENUE	\$ 7,900.3 ^{2/}

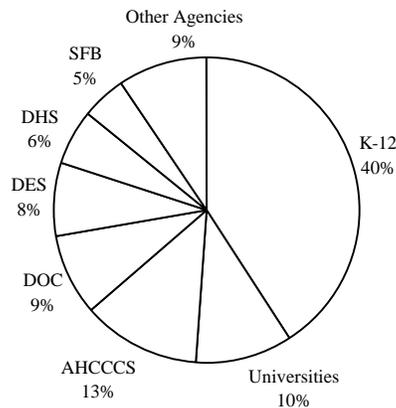


1/ Percentages do not add to 100% due to rounding.

2/ Includes all legislative revenue changes, but does not include beginning balance or other one-time revenue enhancements. The projected beginning balance is \$329.4 million. Other one-time revenues equal \$16.0 million.

FY 2006 General Fund Appropriations - Where it Goes

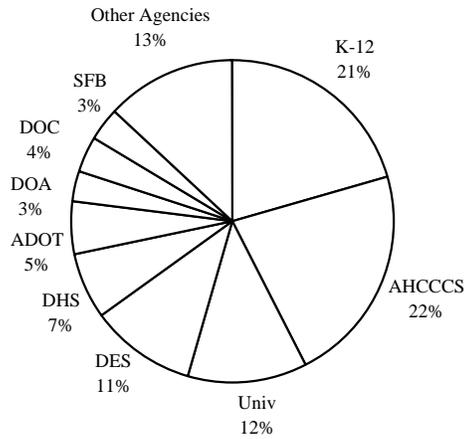
<u>Budget Unit</u>	<u>Appropriation (Millions)</u>
Education (K-12)	\$ 3,342.5
AHCCCS	1,035.1
Universities	843.1
Corrections	697.6
Economic Security	630.2
Health Services	476.8
School Facilities Bd	392.6
Other Agencies	774.0
TOTAL OPERATING BUDGET	\$ 8,191.9 ^{1/}



1/ Does not include administrative adjustments, revertsments maximizing federal funds adjustment, or capital.

FY 2006 Total Operating Spending - All Sources ^{1/}

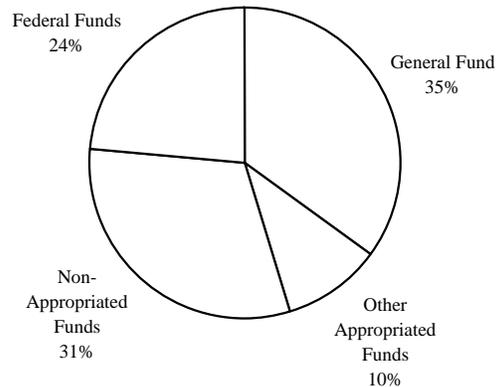
<u>Budget Unit</u>	<u>Spending (Millions)</u>
AHCCCS	\$ 5,159.3
Education (K-12)	4,821.8
Universities	2,793.8
Economic Security	2,485.7
Health Services	1,535.3
Transportation	1,209.9
Corrections	831.5
School Facilities Board	816.8
Administration	744.3
Other Agencies	3,031.5
TOTAL	\$ 23,429.9



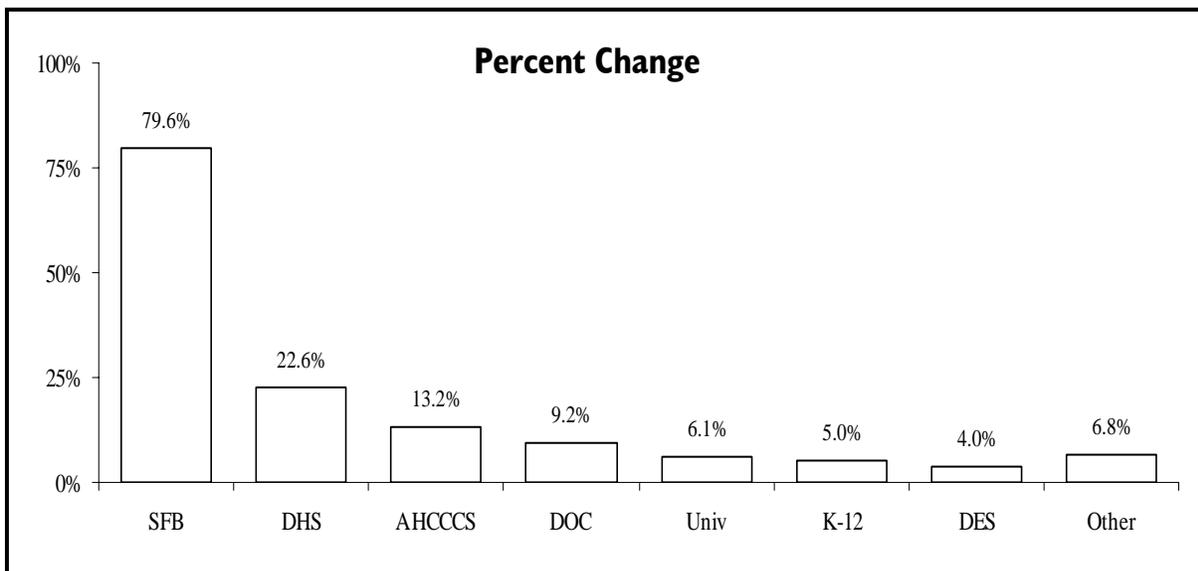
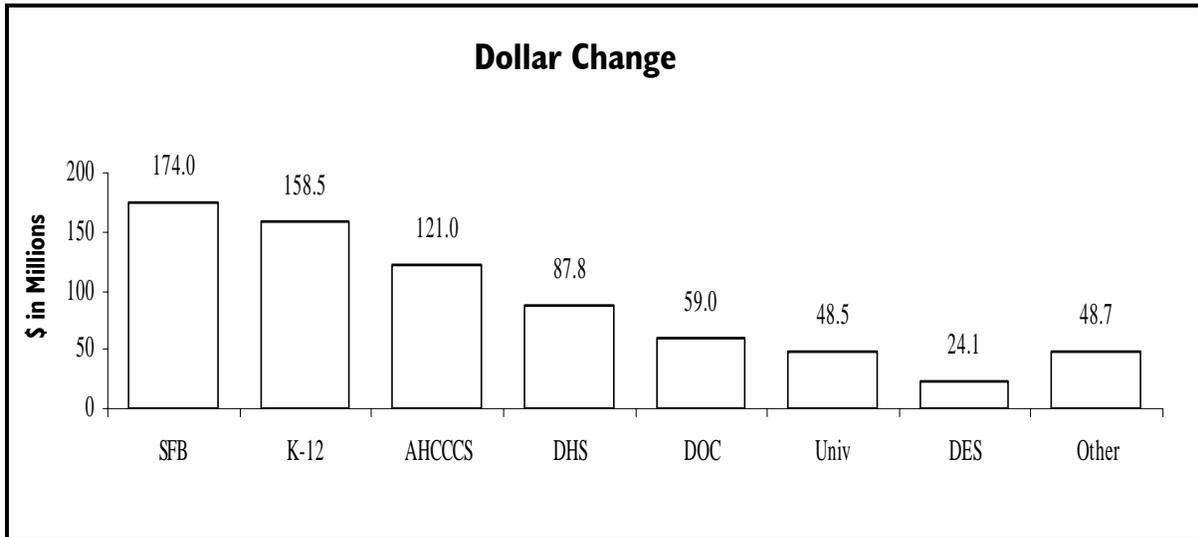
^{1/} Mostly excludes direct state capital expenditures.
Percentages do not add to 100% due to rounding.

FY 2006 Total Operating Spending by Fund Source

<u>Fund Source</u>	<u>Spending (Millions)</u>
General Fund	\$ 8,191.9
Other Appropriated Funds	2,405.6
Non-Appropriated Funds	7,288.0
Federal Funds	5,544.4
TOTAL	\$ 23,429.9



Major Changes to State General Fund Budget FY 2005 to FY 2006



The FY 2006 State General Fund Budget – A Narrative Summary

Overall State Spending

- As enacted, the FY 2006 General Fund budget is \$8.21 billion. Of this amount, \$8.16 billion represents on-going spending and another \$56 million reflect one-time adjustments.
- Overall FY 2006 General Fund spending is growing by \$553 million above FY 2005, an increase of 7.2%. Excluding the \$250 million to convert the New School Construction program from debt to cash financing, the increase is \$303 million, or 4.0%. Excluding one-time items in both years, permanent spending is growing by \$888 million, or 12.2%.
- The FY 2006 ending balance would be \$32 million.
- The entire state budget, including both appropriated and non-appropriated funds, is projected to be \$24 billion.

General Fund Revenues

- The FY 2006 General Fund revenue forecast is \$8.25 billion. This amount includes \$345 million in one-time revenues, consisting of \$329 million from a projected FY 2005 surplus, and \$16 million in transfers from dedicated funds to the General Fund. Based on a consensus forecast, FY 2006 permanent base revenues are projected to increase 7.4% over the current FY 2005 forecast.

Tax Reductions

- The Legislature approved several tax reductions, which will have a total impact of \$18 million in FY 2006. The dollar impact of some of these changes will increase over time. The main elements of the tax package include:
 - ⇒ A 10-year phase-in of a reduction in business personal property taxes, which are anticipated to ultimately cost \$140 million.
 - ⇒ The elimination of the marriage penalty on certain tax credits, an inflation adjustment for the income tax standard deduction and conformity with the federal Internal Revenue code. This bill represents essentially all of the \$18 million in FY 2006 tax reductions.
 - ⇒ Beginning in tax year 2007, a revision in the formula for corporate income tax liability to allow a greater reliance on in-state sales.
 - ⇒ Creation or expansion of income tax credits for small business investments, movie production and gray water conservation systems.

Structural Balance

- The structural balance is the difference between permanent revenues and permanent spending. The state can have a balanced budget, but a structural shortfall, if it uses one-time revenues and/or one-time spending reductions in its budget plan.
- As enacted in May 2004, the original FY 2005 budget had a structural shortfall of \$(283) million. Due to strong revenue growth, the FY 2005 budget is now expected to have a \$122 million surplus. If this estimate was adjusted for the \$250 million of debt-financed new school construction, the surplus would become a shortfall of \$(128) million.
- The FY 2006 budget is currently forecasted to have a \$(258) million structural shortfall. This shortfall is primarily due to the use of \$345 million in one-time unused FY 2005 monies to balance the FY 2006 budget.

Budget Stabilization Fund

- In FY 2005, \$156.5 million was deposited into the state's Budget Stabilization Fund. Prior to this time, the fund was essentially depleted. Based on a statutory formula, the Fund is designed to receive monies from the General Fund in above-average growth years and to transfer monies to the General Fund in below-average growth years.
- In FY 2006, the Fund will receive any excess General Fund revenues above the enacted budget forecast for FY 2006. This provision is otherwise known as a budget "trigger." The BSF statutory formula would require the deposit of \$189 million into the Fund in FY 2006, but the budget trigger places no cap on the level of the deposit. As transmitted, the budget would have triggered any excess FY 2005 revenue into the BSF, but that provision was vetoed by the Governor

State Employee Pay & Retirement

- The General Fund cost of the employee salary adjustments is \$42.6 million.
- State employees will receive a 1.7% increase in their annual salary as of July 2, 2005. For employees in the state retirement system, this adjustment offsets the 1.7% increase in the employee share of retirement costs. For employees in other retirement systems, this represents a net pay increase.
- In addition to the 1.7% adjustment, DPS officers will have an average pay raise of \$1,900 while assistant attorneys general will have an average pay raise of \$4,500.
- Instead of the 1.7% adjustment, correctional officers within the Department of Corrections and Department of Juvenile Corrections will receive a \$1,410 pay raise.
- The budget includes \$22.8 million from the General Fund for increases in the state employer share of employee retirement costs.
- The budget eliminates approximately 1,420 vacant FTE Positions and saves \$7.8 million in associated General Fund state employee health insurance costs.

Education

K-12 Operating Expenses

- Direct state assistance to the operations and maintenance of K-12 schools will grow by \$160 million, or 5.0%.
- The K-12 budget will fund 988,500 students, an increase of 27,500 from the prior year.
- The budget contains an across-the-board 3.2% inflation adjustment in state assistance. Statute requires a 2% adjustment, but the budget added an extra \$45 million for general operating expenses.
- The budget adds \$17 million (for a total of \$38 million) to full day kindergarten programs to serve schools with more than 80% low income students.
- The Governor vetoed the English Learner legislation. The bill would have provided \$28.8 million in additional funding. Of this amount:
 - ⇒ \$15.3 million was to be reallocated from expiring grant programs to new compensatory instruction grants, testing costs and department expenses.
 - ⇒ \$13.5 million would have been an increase in the existing \$62 million "Group B" school funding formula amount. The \$62 million remains in the budget after the veto.

K-12 Capital Expenses

- The budget provides \$250 million in cash for new schools in FY 2006 and \$50 million in FY 2007. In the past 3 years, school construction had been debt financed. The total \$300 million amount provided will fund 35 new school projects that will house 24,000 students.
- \$20 million is set aside to finish the state's \$1.3 billion program to repair schools (known as deficiency corrections).
- School facility building renewal is funded at \$70 million, the same level as in FY 2005.

Universities

- The total Universities General Fund budget of \$843 million will fund 105,100 students in FY 2006. General Fund spending will grow by \$49 million, or 6.1%.
- The budget funds projected FY 2006 enrollment growth at all campuses. Of the \$49 million increase in General Fund spending, \$15.8 million is for salary adjustments, \$14.5 million is for enrollment growth, and \$7 million is for a new medical campus in Phoenix.
- As part of the \$49 million, the budget provides \$4 million to be split between the universities and community colleges for a nursing education demonstration project.

Community Colleges

- The total Community College General Fund budget will grow by \$8 million, or 5.8%. This amount provides 100% of the statutory funding formula.
- The budget increase will fund 6,100 added full time equivalent students and bring total enrollment to 115,900.

Health and Welfare

AHCCCS

- AHCCCS' General Fund budget will increase by \$121 million, or 13.2%, to a level of \$1.04 billion.
- AHCCCS will provide indigent health care services to 43,000 additional recipients. Total caseload is expected to be 1,126,000 by June 2006. Health care provider payments will increase by an average of 6% for inflation.

Department of Health Services

- DHS funding will increase by \$88 million, or 22.6%. Of this amount, \$47 million is due to a technical shift between the General Fund and Tobacco Settlement monies and does not represent new funding for the agency. Another \$38.5 million is for Title XIX-related increases in the department's Behavioral Health and Children's Rehabilitative Services programs. The budget also provides:
 - ⇒ \$4 million for Alzheimer's Research (including \$3 million Tobacco Tax).
 - ⇒ \$3.6 million for a corrective action plan at the Arizona State Hospital.
 - ⇒ \$1 million for abstinence education.
 - ⇒ \$200,000 apiece for Breast and Cervical Cancer and Folic Acid prenatal nutrition programs.

Department of Economic Security

- DES funding will increase by \$24 million, or 4.0%. This amount includes:
 - ⇒ \$20.2 million of new funding for 1,240 new clients in the Developmental Disabilities program. Of this amount, \$6 million is dedicated for provider rate adjustments.
 - ⇒ \$11.2 million of Federal Funds to finance growth in the Child Care program. At this level, the program can serve 47,600 children in FY 2006, an increase of 4,600 from FY 2005.
 - ⇒ \$(15.5) million reduction due to welfare cash benefit caseload declines.
 - ⇒ \$15 million from the General Fund and \$17 million from TANF for caseload growth in Child Protective Services and related foster care, guardianship and adoption services. Increased federal funding provides General Fund savings of \$(4.2) million.

Criminal Justice

Department of Corrections

- ADC funding will increase by \$59 million, or 9.2%.
- Of the \$59 million, \$41 million will allow annualization of prior-year beds and 1,000 new beds to open during the year.

- The budget funds projected inmate growth of 115 net new inmates per month for a FY 2006 year-end inmate population of 34,650.
- ADC is expected to have a bed shortfall of 2,400 by the end of FY 2006. This compares to a shortfall of 4,100 prior to the beds authorized in the fall 2003 Special Session.
- The budget added \$3.5 million (including \$1.5 million from State Trust Lands) for new radio communication equipment and security cameras.
- Correctional Officers will receive a pay increase of \$1,410 per officer.

Department of Juvenile Corrections

- The budget added \$6.7 million of increased funding to address issues related to a federal civil rights audit.
- The budget reduced department funding by \$(7.8) million for a population decline and other adjustments.
- Youth Correctional Officers will receive a pay increase of \$1,410 per officer.

Department of Public Safety

- In addition to the 1.7% state employee pay adjustment, DPS officers will receive an additional average salary increase of \$1,900 per officer.
- The budget provides an additional \$3.5 million to fund 28 additional Highway Patrol officers.

Environment

Department of Environmental Quality

- State funding of the clean-up of chemically contaminated sites, the Water Quality Assurance Revolving Fund (WQARF), will increase by \$1 million to a total of \$11 million.

State Land Department

- The total budget will increase by \$5.2 million. The operating portion includes \$3.1 million to facilitate the sale of state trust lands.

Department of Water Resources

- The department operating budget will increase by \$2.8 million to restore funding cut in prior years.
- The budget also provides \$1.4 million for additional Rural Water Studies.

Capital Outlay

- Legislative Council is appropriated \$15 million in each of FY 2006 and FY 2007 for construction of a new state Archives and History building.
- The Arizona State Schools for the Deaf and Blind is appropriated \$2 million for building projects.