FY 2013 BASELINE

Overview

The FY 2013 Baseline provides an estimate of the state's General Fund balances. The revenue projections reflect a consensus economic forecast while the spending estimates represent active funding formula requirements and other obligations. The Baseline does not represent a budget proposal, but an estimate of available resources after statutory requirements.

As the Legislature begins to work on the FY 2013 budget, the 3-year budget outlook is as follows:

- Given current forecasts of revenues and active formula requirements, the General Fund is expected to generate substantial balances at the end of FY 2012 ($583 million) and FY 2013 ($431 million). In FY 2013, projected revenue of $8.79 billion would be offset by $8.36 billion in spending.
- The FY 2014 budget is projected to have a small shortfall ($172 million), however, with the expiration of the 1-cent sales tax. This estimate does not include the use of prior year balances.
- Changing a few key budget assumptions would significantly alter this outlook. Slightly slower economic growth and plaintiff verdicts in budget lawsuits would create shortfalls of $(360) million in FY 2013 and $(1) billion in FY 2014.

Numerous factors could significantly alter the 3-year budget picture:

- The Baseline estimates assume that the state does not embark on any new permanent spending or tax reduction initiatives.
- If the European debt crisis is not satisfactorily resolved, a potential credit crunch could ultimately affect the U.S. economy.
- Unknown future political events and natural disasters could negatively affect the performance of the economy. Examples of these events in 2011 were the Arab Spring and the Japanese earthquake.
- The 2012 Presidential and Congressional elections could influence the direction on national fiscal policy. Any serious effort to resolve the federal deficit would probably involve a reduction in federal aid to the states.
- Pending "budget" lawsuits at the state level could cost over $475 million if the plaintiffs are successful.

As it is crafting a fiscal policy for the next several years, the Legislature may want to consider:

- Any balances are still projections. At the end of FY 2011, the General Fund balance was $3 million.
- Given the loss of the 1-cent sales in FY 2014, JLBC Staff recommends that we track the impact of FY 2013 decisions on the FY 2014 balance throughout the process.
- 3-year budget forecasts are not reliable. If the revenue forecast has an annual 2% error, total revenues could change by $500 million by the third year.
- The state's lack of reserves in the Rainy Day Fund continues to hamper the state's credit rating. Prior to the recession, those reserves exceeded $600 million.
- The state is still annually suspending over $700 million in statutory funding formulas. If funded, those formulas would eliminate the short-term balances and create a long-term structural shortfall.
- The legislative role in the budget process continues to decline. The General Fund accounts for only 31% of state spending, compared to 44% in FY 2000.

FY 2012

The current estimated FY 2012 surplus is $583 million, an increase of $569 million from the originally-budgeted estimate of $14 million. This increase is primarily due to higher than expected revenues. The projected FY 2012 revenues of $8.91 billion are $578 million higher than the original forecast due to:

- Not having to pay off a FY 2011 shortfall. The original budget assumed that $332 million of FY 2012 revenues would pay off a FY 2011 shortfall of that amount. Due to higher than expected growth, the state ran a slight surplus at the end of FY 2011, thereby freeing up $332 million in the FY 2012 budget.
- The higher FY 2011 revenue base results in higher FY 2012 collections. After excluding all one-time and statutory adjustments, the underlying FY 2012 base revenue growth has been adjusted from 5.6% in the enacted budget to 5.3% in the current Baseline.

While revenues are above forecast by $578 million, spending is $9 million higher due to a loss of expected savings from State Employee Health Savings Account revisions and a technical re-estimation of the level of administrative adjustments and unspent FY 2012 appropriations, otherwise known as revertments.

The $583 million balance estimate assumes that any repayment requirements related to the state's issuance of $1.45 billion in tax-exempt financing in 2010 would not be applicable. *(See Federal 5% Balance Requirements discussion below).*

FY 2013 Baseline Revenues

While base revenues are forecast to grow in FY 2013, one-time factors would reduce FY 2013 collections to $8.79 billion, or $(121) million below FY 2012:

- Based on JLBC's 4-sector consensus, base revenues are projected to grow by $415 million, or 5.1%.
- The state set-aside for urban revenue sharing formula distributions would grow from $424 million to $514 million, thereby reducing state revenue by $(89) million.
- Previously enacted legislative changes would reduce state revenue by $(91) million, primarily from ending the early June sales tax payment of some businesses.
- Discontinuing fund transfers and county cash contributions would reduce revenue by $(357) million.

The 4-sector estimate was developed using a consensus forecasting process. This consensus averages the results of the following 4 forecasts:

- The projections of the Finance Advisory Committee (FAC), an independent 15-member group of public and private sector economists,
- The econometric forecasting baseline model of the University of Arizona's Economic and Business Research (EBR) Center,
- EBR's conservative forecast model, and
- The JLBC Staff forecast.

(See the General Fund Revenue section for more information.)

FY 2013 Baseline Spending

Statutory funding formulas and other obligations are expected to result in FY 2013 General Fund costs of $8.36 billion, a $30 million or 0.4% increase above FY 2012. The major spending changes are as follows:

- Medicaid spending would increase by $99 million due to caseload growth and a reduction in the federal match rate. The Baseline continues to take $(524) million in savings associated with the Executive Medicaid waiver plan.
- K-12 spending would decline by $(28) million, primarily due to a (1.2)% decline in student enrollment and implementation of new restrictions on Homeowner's Rebate eligibility enacted during the last session.
- Lease-purchase and debt service payments are projected to increase by $50 million. This amount includes $35 million to increase the lease-purchase payment on the state's 2010 $1.0 billion state building sale/leaseback from $49 million to $84 million.
- Department of Corrections (ADC) spending would be flat pending legislative decisions with regard to additional prison beds. ADC recently announced it would not award any of the statutorily mandated 5,000 private prison beds and would instead seek authority for 2,000 private beds and 500 state operated beds. The Baseline does not include additional savings for the statutory provision to transfer prisoners with sentences of less than a year to counties starting in FY 2013 due to a lack of information on the fiscal impact. The Governor is proposing to repeal this provision.
- State payrolls would decline by $(79) million due to the elimination of one-time funding for an additional employee pay day. There were 27 scheduled pay periods in FY 2012, compared to the 26 that typically occur in other fiscal years.

The $8.36 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 52,128 state employees. Over 8,600 of those positions, or 17%, are currently vacant. The JLBC Staff recommends that the FTE Position ceiling be revised closer to the filled position level of 43,460 state employees.

Alternative Scenario

While the Baseline represents the primary forecast, a change in a few key assumptions could result in a significant impact on the budget. If the economy grows more slowly than forecast and the state does not prevail in several lawsuits, the budget could have a shortfall of $(360) million in FY 2013 rather than a balance. The currently projected FY 2014 shortfall of $(172) million could fall even farther to $(1) billion.

The consensus economic forecast envisions moderate revenue growth through FY 2014. Several factors, such as the European debt crisis and the unpredictable housing market, could slow both the national and state economy. Other unpredictable influences, such as political events and natural disasters, can always disrupt the economy. If revenue growth is 2% slower than projected (for example, 3.1% rather than 5.1% in FY 2013), General Fund collections would be $(320) million less than expected.

The Baseline estimates assume that the state successfully defends itself in ligation which seeks to overturn certain budget reductions. If the plaintiffs are successful, 3 main "budget" lawsuits could increase state spending by over $475 million. The lawsuits are attempting to overturn:

- The enrollment freeze of the Proposition 204 Medicaid Childless Adult population, which is estimated to save $305 million in FY 2013. (Federal health care legislation, however, requires restoration of this population in January 2014.)
- The 5% Medicaid provider rate reduction, with savings of $98 million.
- The use of a more limited K-12 inflation factor for just transportation costs. If the courts determine that Proposition 301 requires this adjustment to apply also to the per pupil "base level," the cost would be approximately $74 million.

The state is also involved in other budget litigation, but the magnitude of those issues is significantly less.

Lower revenues of $320 million and higher spending of $475 million in FY 2013 would turn the projected $431 million balance into a shortfall exceeding $(360) million. Economic growth and litigation are not the only factors which may affect the state's fiscal picture. If the federal government enacts a comprehensive deficit reduction plan, for example, the level of state aid could decline in programs such as Medicaid.

Debt Rating

With both major credit rating agencies, Arizona has the 4th highest rating out of 10 possible levels (Standard & Poor's: AA- and Moody's: Aa3). In comparison to other states, only California and Illinois have a lower credit rating from Moody's Investor Service. Along with an overall rating, credit agencies also provide an outlook in terms of the future direction of rating changes. For most of calendar year 2011, both major agencies had a negative outlook for Arizona's credit rating. However, Standard & Poor's upgraded Arizona's outlook from negative to stable in December 2011.

In adopting their credit rating for Arizona, both major agencies listed similar concerns, which included depletion of budget reserves, reduced financial flexibility due to restrictions enacted by Proposition 105 and Proposition 108, continued weakness in the housing sector and significant past use of one-time budget solutions. While noting these challenges, the agencies also indicated Arizona's comparably moderate debt levels and long-term population growth as positive trends.

Federal 5% Balance Requirements

As part of solving the FY 2010 budget shortfall, the state entered into $1.0 billion of tax-exempt lease-purchase agreements to fund the sale and lease-back of public buildings. The state also issued $450 million of tax-exempt lottery bonds. Both transactions generated funds to fund state operating expenses. As a condition of issuing tax-exempt financing to fund the operating budget, the federal government essentially requires the state to set aside any subsequent cash reserves above certain thresholds. At the current time, these set aside requirements would be triggered if the state's General Fund balance exceeds 5%.

In FY 2012, the Baseline has a projected balance of $583 million, or $167 million above the 5% threshold of $416 million. In FY 2013, the projected balance of $431 million would be $13 million above the 5% threshold. In total, these "above threshold" amounts would total $180 million across the 2 years.

If the 5% threshold is met between now and FY 2014, the state is required to purchase tax-exempt securities to the extent that the cash balance exceeds 5%. The Treasurer may be able to meet this requirement as part of its ongoing investment of the state's operating fund balance. If these payments can be addressed as part of the state's regular investments, these funds may not need to be appropriated for this specific purpose.

The state could divest itself of these securities if the balance subsequently falls below 5%. Under current projections, the state would not have a balance in FY 2014 with the expiration of the 1-cent sales tax.

Beyond 2014, the state is required to commence early payback of the 2010 issuances if its balance exceeds 5%. Once having commenced early payback, that process is irrevocable.

Other Funds

Besides the General Fund, the state has dedicated special revenue funds. Only a portion of these monies is subject to legislative appropriation. The Baseline includes a FY 2013 Other Fund appropriated spending level of $3.31 billion, or 0.4% above FY 2012.

The level of FY 2013 non-appropriated state funds is expected to be $6.55 billion, while non-appropriated Federal Funds are forecasted to be $9.50 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2013 state spending would be $27.72 billion.

The Baseline includes no fund transfers to the General Fund, a decrease of $(318) million from the FY 2012 total. The Baseline does not, however, increase appropriations to the funds whose appropriation levels were reduced to accommodate some of the fund transfers.

Other Information

Besides providing line item detail on individual agencies, this Baseline book also includes sections with information on the following topics:

- A Narrative Summary of Baseline Assumptions
- Detailed changes and overall totals by agency
- FY 2012 Supplementals and Ex-Appropriations
- Number of State Employees
- Budget Reconciliation Bill provisions
- Major Footnote Changes
- Long-Term General Fund Estimates
- Technical Budget Assumptions