# FY 2014 BASELINE SUMMARY

## Overview

The FY 2014 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.

Laws 2012, Chapter 244 requires that the General Appropriation Act annually delineate the revenue and expenditure projections for 3 years. The budget, however, would only provide actual appropriations for FY 2014.

In terms of the budget outlook:

- Total FY 2014 General Fund revenue is projected to be $8.98 billion, including $651 million in a FY 2013 year-end balance. Revenues would be $(385) million less than in FY 2013. While the 4-sector consensus base revenues are forecast to grow by $416 million, or 4.9%, the state will lose sales tax collections with the expiration of the temporary 1-cent tax.
- In comparison, FY 2014 spending is projected to be $8.67 billion. Medicaid and K-12 account for most of the $157 million, or 1.8%, growth in expenditures, which is limited to current funding formulas and other legal obligations.
- The projected FY 2014 ending balance is $310 million. With ongoing revenues of $8.32 billion and spending of $8.67 billion, however, the budget would have a structural shortfall.
- In FY 2015, the Baseline projected ending balance declines to $25 million after accounting for added revenue growth and statutory spending in that year.
- The FY 2016 Baseline is forecast to have a $(70) million shortfall. This estimate does not include $450 million in the state's Rainy Day reserve (Budget Stabilization Fund).
- The state has accumulated a large budget balance to address the loss of the $(924) million 1 cent sales tax. The Baseline assumes that these large balances will be retained and used as revenue in both the FY 2015 and FY 2016 budgets. If the state instead uses the FY 2014 balance to spend above the Baseline, the FY 2015 budget will effectively become unbalanced and the shortfall in FY 2016 would increase.
- The Baseline does not include the impact of the Court of Appeals' ruling on K-12 inflation. If upheld, the court decision would increase K-12 funding by over $80 million annually. With the cumulative effects of inflation and a reduced beginning balance, FY 2015 would end the year with a $(223) million shortfall. The FY 2016 shortfall would grow from $(70) million to $(346) million.
- Altering other Baseline assumptions can result in a significantly different budget picture. JLBC Staff has developed an Alternate scenario to the Baseline that lowers the 3-year revenue growth rate by 1% and adds $167 million in annual discretionary spending. These assumptions would result in a $(572) million FY 2016 shortfall.

### *Budget Concerns*

- The state has made considerable progress in improving its fiscal condition, compared to the $(4) billion shortfall in FY 2010. Nonetheless, Arizona has the third lowest credit rating among the states. Several components of our budget process still cause concern in the financial markets.
- Especially in light of the loss of the 1 cent sales tax, both the Baseline and Alternate scenarios have structural shortfalls – ongoing revenues are short of ongoing spending.
- The state continues to suspend $678 million in annual statutory formula spending. If the suspensions are not renewed, the budget shortfall would increase by a corresponding amount.
- As a remnant of the recent budget shortfalls, the state pays $1.2 billion of current fiscal year obligations in the next year. While this "rollover" mechanism was used in both the early 1990's and the early 2000's, those debts were paid off by this point in the economic recovery.
- A 3-year forecast comes with risks – a 1% annual change in either revenue or spending estimates would affect the balance by over $500 million in the third year.

### *Budget Risks*

The risks of the current forecast could easily account for a 1% change in the Baseline projections.

- The rate of economic recovery from the Great Recession remains difficult to forecast, as demonstrated by the Federal Reserve Board's decision to leave interest rates near 0% for the foreseeable future.
- The broader federal deficit problems remain unresolved, despite the recent January 1st Congressional legislation. Without further action, federal defense and domestic spending could be reduced by 9% in March 2013. Lower defense contractor spending, for example, could have a negative impact on the Arizona economy.
- Unforeseen political events and natural disasters have economic consequences. Just in the last quarter, Superstorm Sandy demonstrated the disruptive influence of a natural disaster.
- In an increasingly interconnected world, international economics has domestic repercussions. While recent prospects have improved, for example, the euro debt crisis remains unresolved.

Over the 3-year outlook horizon, Consensus base revenues are forecast to grow by an annual average rate of 5.7%. A forecast's probability level provides a prospective on the risk level. Based on input from the 4-sector consensus, the likelihood of meeting or exceeding the 5.7% 3-year revenue growth forecast is 65%. The probability of achieving the lower 4.7% growth rate in the Alternate scenario is 75%.

The forecast risks also exist on the spending side of the equation:

- The mandatory Medicaid costs associated with the Affordable Care Act are largely driven by the expected increase in enrollment of currently eligible non-participants. The Baseline assumes that 50% of that population will enroll in Medicaid due to the higher visibility of this available service. The probability of this projection, however, is no higher than 60%.
- Budget litigation can also change the fiscal picture. On January 15, 2013, the Arizona Court of Appeals ruled that the Legislature is required to fund a fuller measure of K-12 inflation than its current practice. If this decision is ultimately upheld, the cost would be $82 million above the Baseline in FY 2014 and in excess of $250 million over FY 2014 – FY 2016. In addition, the state's budgeted deposit of $50 million of mortgage settlement monies into the General Fund in FY 2013 is also being contested in court.

## FY 2013

The FY 2013 ending balance is currently projected to be $651 million, an increase of $402 million over the original budget estimate of $249 million. Total revenues, including the beginning balance, are forecast to be $9.36 billion compared to spending of $8.71 billion. The $402 million adjustment has 3 main components:

- Increased balance forward from FY 2012. Due to higher than expected growth, the state ended FY 2012 with a carry-forward balance of $397 million, or $275 million above the original forecast.
- Higher ongoing FY 2013 collections, albeit at a lower growth rate. After excluding all one-time and statutory adjustments, the underlying FY 2013 base revenue growth has been adjusted from 5.1% in the enacted budget to 4.0% in the current Baseline. While the growth rate is lower than the original budget, the higher than expected FY 2012 base results in a $67 million increase in revenues above the original FY 2013 estimate.
- Spending is $(60) million lower, mostly due to lower than expected Medicaid enrollment and K-12 formula costs. This savings will appear in the form of unspent FY 2013 appropriations, otherwise known as revertments.

In addition, FY 2013 General Fund individual income tax revenues may be higher than forecast due to an increase in capital gains and dividends. The federal fiscal cliff threat of higher taxes on investor income in January 2013 created an incentive for taxpayers to take capital gains and corporations to issue dividends in the 4th quarter of calendar 2012.

Due to several factors, the Baseline has not incorporated these potential added revenues. First, the magnitude of this impact is highly speculative. Second, this tax shifting may simply accelerate collections from FY 2014 to FY 2013. As a result, any FY 2013 gain may be offset by a FY 2014 loss. Third, the state collected an unrelated one-time individual income tax payment of $60 million in January 2012. If the payment is not repeated again in January 2013, the investor windfall may help offset the loss of the $60 million.

The JLBC Staff suggests that the Legislature consider one of two methods for addressing this issue. One option is to not budget for the windfall. The FY 2013 ending balance may be higher than projected, but those extra monies would absorb the reduction in FY 2014 liability due to the acceleration into the earlier year. A second option is to establish a target for expected individual income tax collections prior to this windfall and dedicate collections above that level to one-time purposes. Since the windfall may simply reflect accelerating income tax collections from one year to the next, the Legislature could also set aside these funds until the future year impacts of the January 1 tax changes are clearer. There may not be sufficient information, however, to establish the target level with any degree of accuracy.

## FY 2014 Baseline Revenues

While base revenues are forecast to grow in FY 2014, the growth is insufficient to fully offset the elimination of the temporary 1-cent sales tax. Overall FY 2014 collections would decline to $8.98 billion, or $(385) million below the revised FY 2013 estimate for the following reasons:

- Based on JLBC's 4-sector consensus, FY 2014 base revenues are projected to grow by $416 million, or 4.9%. Base revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing and new tax law changes. This amount includes implementation of sales tax collections on Amazon purchases, which is estimated to generate $3 million in FY 2013 and $15 million in FY 2014.
- The elimination of the temporary 1-cent sales tax would reduce revenues by $(924) million.
- The state set-aside for urban revenue sharing formula distributions would grow from $514 million to $559 million, thereby reducing state revenue by $(46) million.
- Previously enacted legislative changes would reduce state revenue by $(47) million, primarily from a $3,000 job tax credit and the start of a phased-in 25% reduction of long term capital gain taxation.
- Discontinuing fund transfers would reduce revenue by $(90) million.
- A one-time $52 million gain related to the nonrecurring FY 2013 cost of raising the sales tax early payment threshold.
- A $254 million gain in the balance forward – increasing from $397 million at the beginning of FY 2013 to $651 million at the start of FY 2014.

The 4-sector estimate was developed using a consensus forecasting process. This consensus equally weights the results of 4 forecasts: *(See the General Fund Revenue section for more information.)*

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

## FY 2014 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2014 Baseline spending is projected to be $8.67 billion, a $157 million, or a 1.8%, increase above FY 2013. This estimate excludes the $200 million deposit to the Budget Stabilization Fund in FY 2013. The major adjustments are:

- Prior to mandatory federal health care changes, Medicaid spending would decrease by $(97) million primarily due to slower-than-anticipated caseload growth in FY 2013, a continued Childless Adult enrollment freeze, and an increase in the federal share of program costs. Those savings are partially offset by modest caseload growth in remaining populations and a 2% capitation rate increase.
- The mandatory components of the Medicaid expansion under the federal Affordable Care Act are expected to cost $74 million. This estimate includes higher enrollment of currently eligible non-participants, an expansion in children's eligibility to 133% of the federal poverty level, and both permanent and temporary rate adjustments.
- Department of Education spending would increase by $55 million, due to a 1.2% increase in student enrollment, an increase in the state share of homeowner K-12 property taxes, and an offset from new construction property taxes. This amount includes $8 million for inflating the more limited transportation and charter additional assistance base. If the state concurs with the January 15 Court of Appeals ruling regarding funding the fuller measure of inflation, the added cost would be $82 million above the Baseline.
- Lease-purchase and debt service payments are projected to grow by $20 million. This amount includes a $15 million increase in the state share of the Phoenix convention center debt service payment (to a total level of $20 million).
- Department of Corrections (ADC) spending would increase $9 million to fund legislatively approved prison openings. The cost covers 500 new private medium security prison beds opening on January 1, 2014 and startup costs for 500 state-operated maximum security prison beds anticipated to open on July 1, 2014. Another 500 private beds would be activated in January 2015.
- The financing of $11 million in Land Department operations would return to the General Fund after the Supreme Court ruled that the Permanent Trust Fund could not be used for administrative expenses.
- The Baseline does not continue the one-time $16 million cost of the state employee retention payments or the one-time $(25) million savings associated with a state employee health insurance premium holiday.

The $8.67 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 48,800 state employees.

## Alternate Scenario

While the Baseline represents the primary forecast, the volatility of the outcome can be demonstrated by changing a few assumptions in an Alternate scenario. If revenue growth declines slightly and the budget includes new permanent initiatives, the projected FY 2015 ending balance of $25 million becomes a $(411) million shortfall. The FY 2016 shortfall of $(70) million would grow to $(572) million. The FY 2016 Alternate estimate assumes resolution of the FY 2015 shortfall, otherwise the combined 2-year impact would be $(983) million. These projections do not include use of the $450 million Budget Stabilization Fund, which would be available to offset the shortfall.

Beyond the 4.9% base revenue growth rate in FY 2014, the 4-sector foresees accelerating growth in the longer term with a 5.9% increase in FY 2015 and 6.2% in FY 2016. Across all 3 years, the Baseline average growth rate is 5.7%. Several factors, such as uncertainty over resolution of the federal "fiscal cliff," could slow both the national and state economy. Other unpredictable influences, such as political events and natural disasters, could have unknown impacts. In addition, revenue forecasts traditionally become more cautious with each successive year as the level of uncertainty increases rather than the acceleration in the 4-sector consensus.

Given these potential issues, the Alternate scenario lowers the projected 3-year base revenue growth rate by 1% to a level of 4.7%. The growth rate is held flat at 4.7% for each year, rather than accelerate the growth. By FY 2016, the Alternate revenue projection is $(295) million less than the Baseline.

The Baseline estimates assume that the state does not enact new permanent spending initiatives beyond statutory funding formulas. Based on past experience however, the Legislature has typically added discretionary adjustments to formula spending. The availability of a projected $310 million FY 2014 ending balance increases the possibility of these types of changes.

The Alternate scenario therefore attempts to calculate the potential impact of enacting discretionary spending increases. Numerous Alternate spending plans could be formulated. One of the larger potential adjustments would fund the optional component of the recent federal health care changes. The federal Affordable Care Act (ACA) provides states with the option of expanding coverage of adults to 133% of the federal poverty level (coverage of children at this level is mandatory). In contrast, the Baseline assumes that the state continues its Childless Adult enrollment freeze. The state had previously provided this coverage to any individual with an income below 100% of poverty. The federal government financed this program at its regular match rate of 67%.

If the state selects the ACA option, the federal government would finance 84% of the cost of restoring the childless adults to 100% of poverty and pay the entire cost above 100% of poverty. (By FY 2020, both of these rates would be 90%.) Relative to the Baseline, the adult 133% expansion option is projected to cost $6 million in FY 2014, $103 million in FY 2015 and $89 million in FY 2016. If the state chooses any coverage option less than 133%, the federal government would finance the expansion at the regular 67% match, thereby increasing the cost. The Executive is proposing to fund the 133% expansion option with a hospital provider assessment.

The Alternate scenario contains other adjustments relative to suspended formulas and the continuation of one-time funding:

- New school construction funding of $41 million in FY 2014 and $14 million in FY 2015. The state has been able to place a moratorium on new construction for several years due to the general slowdown in the state's population. The School Facilities Board, however, now estimates that school districts will qualify for new schools over the next several years.
- Continuation of the state employee retention payments, designated as a one-time bonus in the FY 2013 budget and removed in the Baseline, would cost an additional $22 million if annualized for a full year.
- The FY 2013 budget provided the Department of Economic Security with $44 million in non-General Fund monies to backfill the loss of Federal Funds. The availability of that funding source, the Long Term Care System Fund, is expected to decline in future years. While $35 million of funding is projected to be available in FY 2014, no further monies are expected in FY 2015 or FY 2016. The Baseline does not backfill the loss of these funds. The Alternate scenario would cover the difference with General Fund monies in FY 2014 $(9 million) and FY 2015 and FY 2016 ($44 million).

The preceding adjustments are only illustrative and other options could be substituted in their place. For example, the optional Medicaid expansion could be replaced with increases to the Department of Education.

Relative to the Baseline, the Alternate scenario adds $501 million in spending over 3 years – $74 million in FY 2014, $220 million in FY 2015 and $206 million in FY 2016.

Lower revenues of $(295) million and higher spending of $206 million in FY 2016 would turn the projected $(70) million shortfall into a $(572) million imbalance.

## JLBC Staff Suggested Process Improvements

Based on its review of agency requests in preparing this Baseline, the JLBC Staff has developed several suggestions to improve legislative oversight and transparency of government spending, including:

- Arizona Department of Education (ADE) Automation: The department has made progress in improving the K-12 automation system. If additional funding is approved, this project would benefit from increased oversight of an independent contracted third party along with the state's Information Technology Advisory Committee (ITAC).
- ADE Charter School Conversions: Additional school districts are considering whether to convert to charter status, which would increase their per pupil funding. This issue has the potential to have a significant impact on the state share of funding formula costs as each student would cost approximately $1,000 more in the charter system. The Legislature may want to consider clarifying its intent to fund large scale conversions.
- ADE/School Facilities Board Local Initiatives: There is a lack of consolidated information on the magnitude and breadth of school districts' operating and capital overrides and bonding efforts. The JLBC Staff suggests that ADE and the School Facilities Board develop statewide reports on these issues.
- Department of Corrections (ADC): The Legislature approved expanding the prison system by 1,500 beds last year. This expansion may be used to supplant and/or supplement 5,000 temporary beds. To ensure that the state has a consistent policy objective with regard to the use of these new beds, ADC's current bed report should be expanded to address the fate of these temporary beds.
- Department of Economic Security (DES): Of the total funding for Child Protective Services (CPS) and related programs, 45% is from non-appropriated sources. As the Legislature determines the appropriate funding of the CPS system, these non-General Fund monies will play an important role. The Legislature could consider instituting Total Expenditure Authority estimates in the budget bill to account for these resources. A similar budget display is already in use for all Medicaid funding.
- Arizona Department of Transportation (ADOT) Highway Construction: ADOT has several different measures of reporting the funding level of its highway construction program. A joint report of ADOT and the Arizona Department of Administration's (ADOA) General Accounting Office would help ensure accurate calculation of the state's highway construction funding.
- University Performance Measures: The Arizona Board of Regents (ABOR) has made a first step in the development of performance measures by using them to allocate shares of the University budget request among the different campuses. These measures, however, were not used to derive the total performance request. The JLBC Staff recommends that ABOR report on the feasibility of taking this next step in modifying the University funding model.
- ADOA State Employee Health Insurance: Despite transferring considerable monies from the State Employee Health Insurance Fund in the last several years, that fund will have a projected balance of $363 million at the end of FY 2014. Based on a JLBC Staff analysis, additional monies could be transferred from the balance without undermining the fund's structural balance.
- County Reporting: There is no ongoing reporting mechanism to receive information on the state's current funding of county immigration and employer sanction efforts as well as Justice of the Peace salaries. The latter has been underfunded and requires a FY 2013 supplemental of $116,300. The JLBC Staff suggests that the Legislature add a new statutory reporting requirements for both programs.

Further details on the issues raised here can be found in the relevant agency narrative.

## Debt

In FY 2014, the state's projected level of lease purchase and bonding obligations is $8.0 billion. This amount includes:

- $3.3 billion, state and university office buildings
- $1.7 billion, state highway construction projects
- $1.4 billion, school district projects
- $1.3 billion, state operating debt from FY 2011
- $260 million, Phoenix Convention Center

The associated annual debt service payment is $910 million.

Of the $8.0 billion in total obligations, the General Fund share is $3.2 billion. The General Fund annual debt service is projected to be $373 million in FY 2014.

These obligations exclude the $1.2 billion in current year K-12, University and Department of Economic Security payments that are not paid until the following fiscal year, otherwise known as a "rollover." The $8.0 billion estimate also does not include any unfunded retirement liability.

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 rating from both firms. Along with an overall rating, credit agencies also provide an outlook in terms of the future direction of rating changes. Both major agencies have a stable outlook for Arizona.

## 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 2014 Other Fund appropriated spending level of $3.34 billion, or (0.3)% below FY 2013.

The level of FY 2014 non-appropriated state funds is expected to be $7.0 billion, while non-appropriated Federal Funds are forecasted to be $9.9 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2014 state spending would be $28.9 billion.

The Baseline includes no fund transfers to the General Fund except for the $6 million in transfers authorized in the FY 2013 budget for the Judiciary for FY 2014. This is a $(90) million decline from the $96 million in transfers expected in FY 2013.

## Other Information

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

- Narrative Summary of Baseline Revenue and Spending Assumptions
- Detailed Changes and Overall Totals by Agency
- FY 2013 Supplementals and Statutory Changes
- Number of State Employees
- Budget Reconciliation Bill Provisions
- Major Footnote Changes
- General Fund Revenues
- Long-Term General Fund Estimates
- Technical Budget Assumptions