

FY 2020 BASELINE SUMMARY

Overview

The FY 2020 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.

The JLBC Baseline parameters are as follows:

- Total FY 2020 General Fund revenue is projected to be \$12.12 billion. Ongoing revenues are forecast to grow by \$449 million, or 3.9%, above FY 2019. After adjusting these estimates for changes in one-time monies and Urban Revenue Sharing, however, total revenue growth would be \$783 million, or 6.9% above FY 2019.
- In comparison, FY 2020 Baseline formula spending is projected to be \$10.78 billion. This amount reflects a \$390 million, or 3.8%, increase in expenditures over FY 2019. Spending on current funding formulas would be partially offset by decreases in one-time spending.
- The projected FY 2020 cash balance is \$1.34 billion. When comparing ongoing revenues with ongoing spending, however, the structural balance in FY 2020 is \$546 million.

These estimates overstate the level of available resources in the FY 2020 budget for 3 reasons:

- Of the \$1.34 billion cash balance, the Baseline assumes that \$150 million will be reserved in the FY 2020 cash balance, reducing available resources to \$1.19 billion.
- The Baseline eliminates \$92 million of spending that was labeled as "one-time" in the FY 2019 budget. Of the \$92 million, \$81 million is for spending that has been included as one-time spending in multiple years' budgets (*see Table 1*). There may be legislative interest in retaining some of this spending, as well as in other new discretionary spending or tax decreases.
- The FY 2021 and FY 2022 budgets have a much smaller structural and cash balance. As a result, the Legislature could only add about \$200+ million in ongoing initiatives in FY 2020 without producing structural shortfalls in the FY 2021 and FY 2022 budgets. The remaining \$900+ million would be available for one-time proposals.

<u>One-Time '19 Funding</u>	<u>\$ in M</u>
SFB Building Renewal	34
Universities	11
DES - DD Prop 206/Other	13
State Employee Health	10
Counties - DJC/Other	13

FY 2019

The FY 2019 budget is currently projected to have a \$945 million balance, an increase of \$709 million from the original budget estimate of a \$236 million balance. Total revenues, including the beginning balance, are forecast to be \$11.34 billion compared to spending of \$10.39 billion. The net \$709 million adjustment has 3 components:

- Ongoing revenues are \$489 million greater than anticipated, the result of both higher actual FY 2018 and projected FY 2019 growth as compared to the original FY 2019 budget.
- One-time revenues are a net \$225 million greater than anticipated, the result a \$245 million increase in the beginning balance partially offset by a decrease of \$(20) million associated with one-time transfers.
- Spending is projected to be a net \$5 million higher than originally budgeted in FY 2019, primarily due to technical re-estimates.

FY 2020 Baseline Revenues

Both ongoing and one-time revenues are forecast to increase from FY 2019 to FY 2020. Total FY 2020 collections would increase by 6.9% to \$12.12 billion, or \$783 million above the revised FY 2019 estimate. The major adjustments are:

- Based on JLBC’s 4-sector consensus, FY 2020 ongoing revenues are projected to grow by \$449 million, or 3.9%. Ongoing revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing, but do incorporate enacted tax law changes (*see the General Fund Revenue section for more information*). This estimate excludes any impact associated with conforming to the federal tax law changes enacted in December 2017 (*see Other Major Revenue Issues section below for more details*).
- The state set-aside for urban revenue sharing formula distributions would increase from \$675 million to \$738 million, thereby decreasing state revenue by \$(63) million.
- A \$495 million increase in the balance forward between FY 2019 and FY 2020 is the third major adjustment. The state started FY 2019 with a cash balance of \$450 million, but higher-than-projected revenues as noted above are expected to produce an ending balance carried forward into FY 2020 of \$945 million.
- Elimination of one-time FY 2019 fund transfers would reduce revenues by \$(99) million.

FY 2020 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2020 Baseline spending is projected to increase by 3.8% to \$10.78 billion, or \$390 million more than FY 2019. The major adjustments are:

- Department of Education formula spending would have a net increase of \$429 million due to 1.3% growth in student enrollment and a 2.0% inflation factor. The FY 2019 budget also authorized an additional 5% teacher pay adjustment and more additional assistance funding in FY 2020. These growth factors would be partially offset by savings associated with higher K-12 property tax collections.
- AHCCCS formula spending would grow by \$32 million, reflecting 1.7% caseload growth, a 3.0% capitation rate increase, increased match costs for the Children’s Health Insurance Program (KidsCare), offset by use of prescription drug rebate balances.
- The Department of Economic Security (DES) budget would increase by \$37 million, primarily for Developmental Disabilities Medicaid growth.
- Department of Corrections spending would decrease \$(3) million for the elimination of a lease-purchase payment.
- University spending would decrease by \$(13) million, including the elimination of \$(11) million in one-time FY 2019 assistance and \$(3) million for NAU biomedical research funding, as authorized by Laws 2014, Chapter 18.
- School Facilities Board funding would be reduced by \$(38) million, reflecting the elimination of \$(34) million of one-time building renewal monies, \$(2) million for decreased costs of new school construction, and \$(2) million for decreased lease-purchase debt obligations. The Baseline includes a total of \$86 million for new construction, including \$37 million for the second and final year of FY 2019 authorizations and \$49 million for the first year of 7 new FY 2020 authorizations.
- Department of Public Safety (DPS) spending would decrease by \$(30) million for fund shifts to the new Highway Safety Fee authorized in the 2018 Legislative Session. (*See Highway Safety Fee discussion below.*)
- County assistance would fall by \$(13) million due to the elimination of one-time FY 2019 spending for 8 small rural counties and a Department of Juvenile Corrections cost offset. Full-year implementation of the Highway Safety Fee in the Baseline budget would continue to fully undo the local HURF "sweep" as assumed in the FY 2019 budget’s 3-year spending plan.
- Agency budgets would be reduced by \$(10) million statewide to eliminate a one-time state employer health insurance increase.

The \$10.78 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 53,082 state employees from both General Fund and Other Appropriated Funds.

Other Fiscal Challenges

There are 3 important aspects to consider in creating a budget: 1) managing risk in setting the economic and revenue forecast, 2) setting spending and revenue priorities, and 3) ensuring both a structural and cash balance through the 3-year planning period.

Managing Forecast Risk

There are both positive and negative risks to the JLBC Baseline revenue estimates:

- *Length of Expansion:* The length of the current national economic recovery is approaching the record for the longest post-World War II expansion. If the economy makes it through FY 2019 without a recession, it would tie the record at 120 months.
- *Recession Likelihood:* While recessions are more commonly the result of a "shock" rather than "old age," many economists think one could occur by the end of calendar year 2020. Approximately two-thirds of 60+ leading economists in recent *Wall Street Journal* surveys predict the onset of a recession by that time. The current Chinese trade dispute, rising interest rates and the year-end stock market drop are the primary reasons for the forecasters' pessimism.
- *Current Strong Revenue Growth:* As of now, however, Arizona's economy and its revenue growth are still strong. The state ranks fourth overall in the country in terms of its economic momentum (personal income, population, and employment growth). Arizona has experienced healthy revenue growth of 6.9% in FY 2018 and 6.8% year-to-date in FY 2019.

The four-sector forecast projects 7.0% revenue growth through the end of FY 2019, but growth in FY 2020 through FY 2022 that is less than the long-term average of 4.25%. Because small percent changes in growth assumptions can have a substantial impact – over 3 years, a 1% change in revenue growth could change available revenues by \$725 million through FY 2022 – these risks could significantly change the final results of these budgets.

Setting Priorities

As noted above, the Baseline is only a starting point for budget discussions as it reflects changes to active statutory and other funding formulas and does not include discretionary changes. The FY 2020 Baseline has a large projected ending cash balance, but with a comparatively small amount of that available for ongoing spending (*see Ensuring Long-Term Balances below*). As a result, the Legislature will also need to consider the most appropriate use for the \$900+ million available for one-time initiatives.

The Baseline reserves \$150 million in the FY 2020 ending balance to keep the FY 2021 cash balance at a sufficient level to support \$200+ million in ongoing initiatives through FY 2022. The following list of items are options for allocation of the remaining 900+ million FY 2020 ending balance:

- Continuation of the \$81 million in reoccurring "one-time" spending from FY 2019 and zeroed-out in the Baseline
- Budget Stabilization Fund deposit
- K-12 building repair spending
- Transportation projects
- Debt repayment
- "Buy down" of K-12 rollover
- New (and renovation of) state office buildings
- Automation improvements

Ensuring Long-Term Balances

While the FY 2020 Baseline has a significant structural and cash balance, these balances decline through the end of the 3-year planning period. The smaller structural balances in FY 2021 and FY 2022 limit the state's ability to dedicate more than \$200+ million to ongoing initiatives in FY 2020. Beyond new spending and revenue issues, the Legislature may also consider allocating some of the \$200+ million towards making some or all of \$81 million of the reoccurring "one-time" spending ongoing.

In addition to the spending items listed above, the state faces ongoing litigation that may impact budgets such as:

- The K-12 Capital Funding litigation in Maricopa Superior Court.
- Litigation against the Department of Child Safety in United States District Court. The case was granted class-action status.
- The Rental Car surcharge litigation has a potential one-time impact of \$150 million. A Maricopa Superior Court has ruled that the rental car surcharge used to help fund the Arizona Sports and Tourism Authority is unconstitutional as those monies are to be dedicated for transportation. The Court also ruled that the state, and not the Authority, had the initial legal responsibility to repay the collected surcharges. While the Arizona Court of Appeals overturned the

ruling in favor of the state, the Arizona Supreme Court has decided to hear the plaintiffs' appeal of the Appeals Court ruling.

Other Major Revenue Issues

In addition to these challenges, the Baseline does not address 3 major actions on the federal level from the past 13 months that could potentially impact Arizona revenues:

- **State Tax Conformity:** Major federal tax changes known as the Tax Cuts and Jobs Act (TCJA) were enacted on December 22, 2017. The changes reduced the overall federal tax burden to businesses and individuals through reductions to federal income tax rates, partly offset by a net expansion of the federal income tax base. Due to tax code conformity, these federal changes have the potential to impact state revenues.

In Arizona, state definitions of income and various deductions used in determining state individual income and corporate income tax largely conform to federal definitions. When the federal government changes these definitions, the state needs to determine whether to adopt the federal changes. Thus far, no legislation to conform to the recent federal tax law changes has been enacted for Tax Year 2018.

If the state were to conform to the federal tax law changes, the JLBC Staff estimates that Arizona would collect an additional \$133 million of General Fund revenues in FY 2019, and \$184 million in additional revenues in FY 2020. These additional revenues are not incorporated into the Baseline revenue forecast. In January 2018, the Department of Revenue estimated an impact of \$50 million to \$250 million in additional General Fund revenues, with a point-estimate of \$236 million. In December 2018, the Executive released an estimate of conformity generating between \$180 million and \$200 million of General Fund revenues.

- **Wayfair Court Case:** In June 2018, the U.S. Supreme Court overturned in *South Dakota v. Wayfair* prior rulings by the same court, which had held that only businesses with a physical presence (“nexus”) inside a state be required to collect that state’s sales tax. The *Wayfair* ruling essentially “paved the way” for states to start collecting sales tax from out-of-state (“remote”) sellers. Prior to this ruling, buyers of goods from remote vendors were legally required to pay use tax on such purchases. In practice, however, the use tax compliance among consumers was low. Based on the prorating of national estimates, the state General Fund revenue gain from the *Wayfair* ruling could potentially be \$85 million annually. It is currently unclear, however, what legal actions that the state must take before tax from remote sellers can be collected. Due to this uncertainty, the Baseline does not include any revenues from the *Wayfair* ruling.
- **Sports Betting:** In May 2018, the U.S. Supreme Court ruled the Professional and Amateur Sports Protection Act (PASPA) of 1992 to be unconstitutional. PASPA prohibited states from authorizing sports gambling. As a result of this ruling, states (including Arizona) are now allowed to impose a tax on sports betting. The potential revenue gain for Arizona is uncertain, as it would depend on several factors, including whether sports betting would be limited to Tribal-owned casinos only or be expanded to include retail locations (e.g. off-track betting locations) and online betting. In addition, the net revenue gain would also depend on the tax rate and to what extent sports betting would displace other forms of gambling. Due to these uncertainties, the Baseline does not include any tax revenues from sports betting.

(Please see General Fund Revenue Summary Section for more information on these 3 items.)

Highway Safety Fee

The historical usage of Highway User Revenues Fund (HURF) and State Highway Fund monies in the DPS budget resulted in monies being diverted from local government road construction and state highway construction. HURF monies are used to fund state and local road construction. Roughly 50.5% of HURF revenue goes to state highway construction and 49.5% goes to cities and counties for local road construction.

Laws 2018, Chapter 265 establishes a new Highway Safety Fee to fund DPS's Highway Patrol budget, so that DPS would no longer be funded from HURF. Chapter 265 requires the Director of the Arizona Department of Transportation (ADOT) to set the fee on vehicle registrations to fund 110% of the Highway Patrol budget for each fiscal year.

In November 2018, ADOT announced the Highway Safety Fee, which became effective December 1, 2018 for new vehicle registrations and effective January 1, 2019 for vehicle renewals. As a first step in calculating the fee, ADOT determined the DPS Highway Patrol Budget to be \$168 million. The additional 10% required by Chapter 265 is \$16.7 million. As a result, the fee is expected to generate \$185 million on an annual basis. ADOT estimates that approximately 5.8 million vehicles will be eligible for registration in 2019. The 5.8 million estimated number of vehicle registrations, along with the \$168 million Highway Patrol budget, resulted in a \$32 fee per vehicle, with off-highway vehicles paying \$5 per vehicle per year.

Since this new fee will be effective January 1, 2019, it is expected to raise roughly half the \$185 million in FY 2019, or \$91 million.

In FY 2020, the fee will pay the complete cost of the Highway Patrol budget. As a result, current funding for Highway Patrol will be redirected. This includes:

- Elimination of a full year of \$99 million in HURF for DPS expenses, which will be redirected to state and local road construction.
- Elimination of \$30 million in General Fund for DPS expenses, which will be replaced by the Highway Safety Fee. This amount was added to the DPS General Fund budget to replace HURF dollars in FY 2015.
- Redirection of \$23.2 million of Insurance Premium Tax (IPT) from Highway Patrol Fund to the General Fund. The IPT revenues had previously been deposited into the Highway Patrol Fund to supplement the Highway Patrol budget. With the creation of the Highway Safety Fee, these monies can be directed to the General Fund. Most IPT revenues are already deposited into the General Fund. The \$23.2 million estimate is based on the actual FY 2018 distribution.
- Reduction of \$7.5 million in State Highway Fund spending for Highway Patrol, which will be replaced by funding from the Highway Safety Fee. These freed-up monies in the State Highway Fund will be transferred to the General Fund through Vehicle License Tax (VLT) revenues.
- Continued funding of the \$7.3 million in new troopers added in FY 2019.
- Deposit of the excess \$16.7 million in Highway Safety Fee funds to the General Fund. This amount reflects the extra 10% of the Highway Patrol Budget. These monies will first be transferred to the State Highway Fund and then transferred to the General Fund through VLT revenues.

In total, the General Fund will benefit by \$107.4 million:

- \$30.0 million from eliminating a planned increase in funding to support local HURF.
- \$30.0 million from the 2015 DPS budget shift.
- \$23.2 million from diverting IPT from the Highway Patrol Fund to the General Fund.
- \$24.2 million of transfers from the State Highway Fund to the General Fund: \$16.7 million is from the 10% "Excess" Highway Safety Fee revenue and \$7.5 million is from freed up State Highway Fund monies no longer used in the DPS operating budget. These monies in the State Highway Fund will be transferred to the General Fund through VLT revenues.

Transportation spending will increase by \$69 million, including \$19 million to local HURF and \$50 million to the State Highway Fund.

Debt

At the end of FY 2020, the state's projected level of lease-purchase and bonding obligations will be \$6.8 billion. The associated annual debt service payment is \$917 million.

Of the \$6.8 billion in total obligations, the General Fund share is \$1.7 billion. The General Fund annual debt service is projected to be \$317 million in FY 2020 (*see the Debt and Lease-Purchase Financing section of the Capital Outlay narrative for additional information*).

As a remnant of the Great Recession, the state also pays \$931 million of current year K-12 obligations in the next year (the “rollover”). The \$6.8 billion estimate of total obligations also does not include any unfunded retirement liability.

Arizona's credit rating was last changed in May 2015. Both major credit rating agencies upgraded Arizona’s credit rating. Standard & Poor’s upgraded Arizona from AA- to AA, while Moody’s upgraded Arizona from Aa3 to Aa2. Both ratings represent the agencies’ third highest rating out of 10 possible levels. Using Standard & Poor’s credit ratings as of December 2018, in comparison to other states, 25 states have a higher rating, 15 states have the same rating, and 9 states have a lower rating or are not rated due to a lack of state level debt. Along with an overall rating, credit agencies also provide an outlook in terms of the future direction of rating changes. Since May 2015, both major agencies have maintained a stable outlook for Arizona.

More recently, Standard & Poor's upgraded its rating on Arizona's 2010 Lottery bonds to AA+ from AA. While the rating only applies to the Lottery bonds and not the state's overall rating, Standard & Poor's cited the state's broad and diverse population base and growth in the past decade as one reason for the improved outlook.

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 2020 Other Fund appropriated spending level of \$4.5 billion, or 0.7% above FY 2019.

The level of FY 2020 non-appropriated state funds is expected to be \$10.0 billion, while non-appropriated Federal Funds are forecast to be \$16.7 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2020 state spending would be \$41.9 billion.