JLBC Staff - October 2012 Revenue and Budget Update

Summary of the General Fund Budget Outlook

- While the state ended FY 2012 with $275 million more in the ending balance than expected, FY 2013 growth since July has been slower than forecast.
- Using the 4-sector forecast, Baseline revenues are projected to grow by 5.8% to 6.3% annually between FY 2014 and FY 2016.
- JLBC Staff has developed 2 scenarios for its budget forecast through FY 2016. Two factors will especially influence these estimates:
  - The rate of recovery of the U.S. economy and the potential impacts of efforts to reduce the federal deficit.
  - The future of the federal health care legislation, including whether to restore childless adult coverage in Arizona.
- In the Baseline scenario, revenues grow at the 4-sector rate and the state continues its current freeze on childless adult coverage.
  - The state would accumulate large balances (for example, $368 million in FY 2014) in the short run. By FY 2016, the balances will have been depleted and the projected shortfall is $(67) million. The state, however, would still have a $450 million Rainy Day Fund.
- In the Alternate scenario, revenue growth is capped at 5% in light of general economic uncertainty. Childless adult coverage is restored to 100% of the poverty level and several other expiring initiatives are continued.
  - The balances would be spent down more quickly and there would be a projected $(411) million shortfall in FY 2015 and $(583) million in FY 2016.

Besides this document, the JLBC Staff has also developed a slideshow presentation of this issue that can be found on the JLBC website at: October 4 FAC Meeting.

The Caveats

1) We have limited ability to predict the future 45 months in advance of the end of FY 2016.

2) Long term budget forecasts are subject to considerable change -- a 1% error would change available resources by over $500 million in the third year.

3) The availability of short term balances may result in the enactment of new permanent tax reduction and spending initiatives, which would further increase shortfalls in the outyears.

4) The budget scenarios assume the continuation of temporary statutory suspensions -- if funded, the balance would decline by another $(632) million.

5) As the 1 cent ballot initiative is essentially designated for new spending, those monies would not be available to offset any shortfall.

Reporting Requirements

The General Appropriation Act requires JLBC Staff to report by October 15, 2012 as to whether FY 2013's General Fund revenues and ending balance are projected to change by more than $50 million from the budgeted projections. In addition, Laws 2012, Chapter 244 will require the Legislature to add 3-year estimates to each year's budget bill. In preparation for these requirements, JLBC Staff has reviewed the preliminary FY 2012 ending balance estimates and updated its 4-sector revenue revenue projections in conjunction with the October 4th Finance Advisory Committee (FAC) meeting. In addition, JLBC Staff has revised its spending projections through FY 2016.

Updated FY 2012 Estimates

The enacted May budget originally assumed a FY 2012 ending balance of $122 million. Due to greater than expected revenues and reduced caseload spending, the Arizona Department of Administration's (ADOA) projected FY 2012 ending balance is $397 million, or $275 million higher than forecast. ADOA will publish a final FY 2012 ending balance figure by December 1.

In terms of revenue, the budget projected that FY 2012 base revenues (excluding one-time adjustments) would increase by 5.3% compared to the prior year. Instead, base revenues grew by 6.7%, driven by strong Individual Income Tax payments along with growth in the other "Big 3" categories.

In addition, FY 2012 had higher than expected revertments (unspent appropriations), which led to lower than budgeted spending levels. This was due to caseload agencies, such as AHCCCS and the Arizona Department of Education (ADE), having fewer program participants than originally estimated.

FY 2013 - 2016 Revenue Projections

The enacted FY 2013 budget assumed base revenue growth of 5.1%. As this growth rate does not account for one-time adjustments, enacted tax law changes and urban revenue sharing, it is intended to provide a perspective on the underlying growth of the economy. Based on preliminary September projections, however, first quarter FY 2013 General Fund revenues are 3.6% above last year. This year-to-date figure reflects the change in total revenues, however, the impact of tax law changes up to this point in FY 2013 is minimal.

In the first quarter of FY 2013, Sales tax collections were up by 3.8%, Individual Income tax collections grew by 4.6%, and Corporate Income tax collections increased by 1.2%. In total, General Fund revenues are $(3.7) million below the budget forecast enacted in May.
The FY 2013 to FY 2016 forecast is based on the input from the following 4 sources (each equally weighted): members of the FAC panel, University of Arizona's "base" and "low" econometric revenue models, and JLBC Staff. Under the updated 4-sector consensus forecast,

base General Fund revenues are projected to grow by 4.3% in FY 2013, 5.8% in FY 2014, 5.7% in FY 2015, and 6.3% in FY 2016. The FY 2013 growth rates range between 0.6% in the UA - low risk model to 6.8% in the UA - base forecast. The UA models again provide the low and high point for FY 2014, with the Low being 3.4% and the Base being 7.3% growth. Details of the October 2012 consensus forecast are summarized in *Attachment A*.

Tax Law Changes The base revenue forecast is further adjusted for enacted tax reductions and Urban Revenue Sharing (URS) distributions. Relative to the current budget, enacted tax laws will have a General Fund impact of $(67) million in FY 2014, $(223) million in FY 2015 and $(357) million in FY 2016. Some of these adjustments will increase ADE spending by reducing the level of local property tax collections available to fund the K-12 formula. Apart from these spending issues, the actual revenue impact will be $(47) million in FY 2014, $(180) million in FY 2015 and $(289) million in FY 2016. These estimates reflect the nominal values of the tax reductions. They are not adjusted for any offsetting economic activity which may be generated by the tax reductions. The major provisions are detailed in the JLBC Staff presentation.

Urban Revenue Sharing Under the current URS program, the state shares 15% of net Individual and Corporate Income tax collections from 2 years prior with incorporated cities and towns. URS will grow from $514 million in FY 2013 to $559 million in FY 2014. This $45 million gain to cities and towns results in a corresponding loss of revenue to the General Fund. Under the updated consensus forecast, URS distributions are projected to be $587 million in FY 2015 and $624 million in FY 2016.

Temporary 1 Cent In FY 2014, the temporary 1 cent sales tax will expire and the state will lose $(922) million in revenue. The 2012 General Election will include a ballot initiative for a permanent 1 cent sales tax. If approved by the voters, these monies are essentially dedicated to new programs and would not be available for General Fund purposes. The loss of temporary 1 cent revenue is somewhat offset by a projected FY 2013 ending balance of $676 million which will be available as revenue in FY 2014.

After factoring in all these adjustments, General Fund revenue is forecast to fall from $9.39 billion in FY 2013 to $9.11 billion in FY 2014. The bottom line revenue growth in FY 2015 and FY 2016 will be relatively low as less of the ending balance will be available to support overall revenues in those years. General Fund revenue is projected to be $9.15 billion in FY 2015 and $9.29 billion in FY 2016.

Risks to the Revenue Forecast

As with any long term revenue projections, there are risks to the forecast:

- Natural disasters or unexpected geopolitical events often have economic consequences.
- The Federal Reserve Board recently extended its 0% interest rate policy to at least the middle of 2015. This decision suggests that the central bank sees considerable challenges ahead for the economy.
- International economics is even further beyond our control - Europe's debt crisis and the slowing of the Chinese economic boom could have impacts on the United States economy.

- The looming federal "fiscal cliff" could affect both the short and long term prospects for economic growth. Under current law, a number of tax reductions enacted over the last 10 years will be rolled back, beginning January 1, 2013. Additionally, as a result of Congressional failure to agree on deficit reduction last year, automatic spending reductions will be triggered under the Budget Control Act, beginning in January 2013. Thus, unless Congress acts to extend expiring tax provisions and repeal automatic spending reductions before the end of this calendar year, many economists believe that the U.S. economy could fall into another recession in 2013.

  Under this "falling off the fiscal cliff" scenario, the federal deficit would be reduced by $700 billion. While such an action would help our long term growth prospects, this level of tax increases and spending cuts in 1 year would likely result in low or negative economic growth in the near term. This in turn would adversely affect state revenue collections. Alternatively, the fiscal cliff may be avoided by either extending all or some of the expiring tax provisions. The impact on the economy and related tax collections under the "avoiding the cliff" scenarios will largely depend on when and how deficit reduction is addressed after 2013. This introduces further uncertainty to any multi-year forecast.

- The 4-sector forecast accelerates revenue growth in the outyears, growing from 5.8% in FY 2014 to 6.3% in FY 2016. Long term forecasts, however, typically become more cautious with each succeeding year due to all of these types of uncertainties.

To address these various contingencies, the JLBC Staff has developed an alternate forecast scenario that caps base revenue growth at 5.0% annually for the period from FY 2014 through FY 2016. The JLBC Staff used the same approach at last April's FAC meeting. This change would reduce total General Fund revenues to $9.04 billion in FY 2014, $8.87 billion in FY 2015 and $8.56 billion in FY 2016.

The level of projected General Fund revenues under the 2 scenarios is summarized in *Table 1* below**.**

Table 1

Comparison of Revenue Forecasts
($ Billions)

Forecast Scenario	**FY 2014**	**FY 2015**	**FY 2016**
4-sector			
Beginning Balance	$0.68	$0.37	$0.07
On-Going Revenue	8.43	8.78	9.22
Total Revenue	**$9.11**	**$9.15**	**$9.29**
Alternate			
Beginning Balance	0.68	0.23	(0.41)
On-Going Revenue	8.36	8.64	8.97
Total Revenue	**$9.04**	**$8.87**	**$8.56**

Future Year Spending Estimates

The JLBC Staff has also updated its FY 2013 to 2016 Baseline spending estimates. The Baseline reflects the standard methodology of estimating the annual growth in statutory and other active funding formulas. The Baseline incorporates the following adjustments:

- K-12 state aid formula growth. Student growth is expected to increase by an annual average of 1.0% through FY 2016. Two enacted policy changes will also increase K-12 expenses. The business property tax assessment ratio will decline from 20% to 18% over 4 years starting in FY 2014. To prevent shifts to residential property taxpayers, the Homeowner's Rebate will also increase during this same period of time. In total, K-12 spending is projected to increase by $71 million in FY 2014, $68 million in FY 2015 and $94 million in FY 2016.

- Medicaid caseload growth in AHCCCS, the Department of Health Services and the Department of Economic Security. Prior to new federal health care requirements described below, annual caseloads are expected to grow by 3% while the monthly capitation payments would increase 3% per year during most of the forecast period. These adjustments increase the Medicaid budget by $119 million in FY 2015 and $129 million in FY 2016. FY 2014 Medicaid spending, however, is projected to decline slightly due to a base adjustment related to the overfunding of caseloads in FY 2013.

- The phase-in of Department of Corrections (ADC) prison beds. The Legislature has already approved the addition of 500 new private prison beds in January 2014 and another 500 in January 2015. The state will also open 500 new maximum public beds in FY 2015. The operating costs of all these new beds are expected to add $9 million in FY 2014, $19 million in FY 2015 and $7 million in FY 2016.

In terms of standard funding formula requirements, overall spending is projected to grow by $149 million in FY 2014 (1.8%), $202 million in FY 2015 (2.3%) and $233 million in FY 2016 (2.6%). The individual components of these adjustments can be found in the JLBC Staff presentation.

The Baseline also assumes the continued annual suspension of any inactive formulas. Each year, the Legislature enacts certain provisions which serve to only suspend, not repeal, certain statutory formulas. If those inactive formulas were counted in the Baseline, spending would increase by $632 million. The detailed list of inactive formulas can be found in *Appendix B* of the JLBC Staff presentation.

Affordable Care Act Estimates

The federal Affordable Care Act (ACA) will require changes in the state's Medicaid program starting in January 2014. The Baseline spending estimate incorporates the mandatory impacts of the ACA legislation:

- States are required to expand coverage to children up to 133% of the federal poverty level (FPL). This cost will be relatively small, however, as most children below 6 are already eligible for Medicaid. This policy would primarily affect children between 6 and 18 years of age, who currently qualify at 100% of FPL.

- The second and more expensive factor is the potential enrollment of already eligible non-participants below 100% FPL. While ACA imposes fines on individuals not enrolled in a health plan, these penalties will not extend to the Medicaid non-participant population. Nonetheless, the publicity surrounding implementation of these federal health care requirements is expected to induce some of the currently eligible non-participants to enroll. The Baseline estimate assumes that half of the 265,000 individuals below 100% FPL enroll in Medicaid.

These mandatory provisions are expected to add 156,000 persons to Medicaid and create additional costs of at least $69 million in FY 2014 and another $170 million in FY 2015.

Beyond these mandatory costs, the state will also have certain options with regard to adult coverage, which would further increase costs in FY 2014 and FY 2015 above the Baseline. The original ACA would have required states to cover the adult population or face the loss of all of its federal Medicaid funds. Due to the United States Supreme Court ruling, however, adult coverage became optional.

Prior to an enrollment freeze in 2011, the state covered childless adults up to 100% FPL. As a result of the freeze, participation has declined from 210,000 to 94,000 currently. The freeze did not affect adults with children and they continue to be eligible up to 100% FPL. Since it represents current policy, the JLBC Baseline assumes continuation of the Childless Adult freeze through the forecast period. The federal agreement to participate in the enrollment freeze, however, expires at the end of December 2013.

Under the ACA option, the federal government would cover adults up to 133% FPL. If Arizona chooses this option, the federal government would finance 85% of the cost of restoring Childless Adult coverage to 100% FPL and 100% of the cost of all adults between 100% and 133% FPL (the regular federal match rate is 66%). Relative to the JLBC Baseline, this option would increase participation by another 167,000 participants and cost another $135 million in FY 2015. In the long run, the federal government is scheduled to: 1) increase its financing of the under 100% population to a 90% match rate by 2021; and 2) reduce its financing of the 100% + population to a 90% match rate by 2020.

Given the flexibility under the Supreme Court ruling, the state could also choose to set childless adult coverage at less than 133%. If a state does not choose full expansion, however, it is unclear whether the federal government would provide the enhanced match rate. If the state chooses to set coverage at 100% FPL, the federal government could potentially fund only the adult population at the regular match rate of 66%. AHCCCS has published a draft proposal to restore the Childless Adults at the enhanced rate, but has not yet received a reply from the federal government.

As a result, 100% FPL childless adult coverage could have one of 2 costs above the JLBC Baseline:

- $135 million if the federal government provides the enhanced 85% match. This is the same cost as the 133% expansion as the federal government would finance all of the cost between 100% and 133% FPL.

- $478 million if the federal government only funds the childless adult restoration at the regular 66% match rate.

These long term federal health care estimates come with several risks:

- Modeling potential enrollment is extremely challenging as numerous factors affect decisions to participate in Medicaid. For example, the state expanded participation to 100% FPL in the early 2000's as a result of a ballot initiative. While that change was originally estimated to add 100,000 new enrollees, the ultimate growth was closer to 200,000.

- These estimates could be revised upward if the federal government changes its Medicaid match rates as part of its own efforts to address the broader federal deficit.

Summary of Different Spending Levels

In summary, long term spending will depend on regular funding formula growth, the mandatory federal health care expansion and the state's decision with regard to optional federal health care costs. In addition, the projection of large year-end budget balances in FY 2013 and FY 2014 may create pressure to continue one-time FY 2013 spending initiatives as well as increase spending for existing or new programs.

Numerous spending proposals could be offered in the next regular legislative session. If spending grows beyond normal formula growth, there are 2 one-time FY 2013 initiatives that may be considered for ongoing funding. First, DES received $44 million in federal Long Term Care System Fund monies to backfill the loss of Federal Funds. If those Long Term Care monies are not available again, the state may decide to continue the backfill with General Fund dollars. A second initiative was a one-time pay bonus for non-covered state employees as of September 29, 2012. These employees had their annual salary level increased by 5% as of this date (which equates to 3.75% for the remainder of the fiscal year). If made permanent, this salary adjustment would cost $22 million annually, pending further analysis of the number of employees who transferred to uncovered status.

To address these issues, JLBC Staff has developed 2 expenditure scenarios:

- Under the Baseline Scenario, the state would fund regular statutory formulas and minimum ACA requirements, continue the current AHCCCS Childless Adult freeze, and would not restore any major one-time funding sources used in the FY 2013 budget.

- The Alternate Scenario attempts to reflect some of the additional spending options. The Alternate Scenario includes the restoration of the AHCCCS Childless Adult coverage at the enhanced (85%) match rate, continuation of the 5% salary adjustment at the full annual cost, and replacement of the $44 million of one-time DES funding from the Long Term Care System Fund in the current budget with General Fund monies.

Tables 2 and 3 summarize potential spending changes. In FY 2014, the combination of the regular formula costs and the minimum federal health care requirements are projected to total $218 million. *(See Table 2)*

In the Alternate Scenario, the FY 2014 level spending would further grow depending on the state's choices. *(See Table 3)*

Table 2

Projected Growth Over Prior Year Spending
($ in Millions)

Baseline	FY 2014	FY 2015	FY 2016
Current Statutory Funding	$149	$202	$233
Mandatory Federal Health Care	69	170	45
Baseline Total	**$218**	**$372**	**$278**

Table 3

Alternate Scenario Options Above the Baseline
($ in Millions)

Health Care Expansion	FY 2014	FY 2015	FY 2016
- Enhanced Match	$ 9	$135	$125
- Regular Match	83	478	593
DES Backfill	44	44	44
State Employee Pay	22	22	22

The Baseline scenario would result in a $8.74 billion spending level in FY 2014 followed by $9.08 billion in FY 2015 and $9.36 billion in FY 2016. If the state pursued the options described above, the Alternate spending level (with an enhanced federal match) would rise to $8.81 billion in FY 2014, $9.28 billion in FY 2015 and $9.55 billion in FY 2016.

Future Year Balance Projections

As noted above, the JLBC Staff has developed both a Baseline and Alternate budget scenario. These projections are not intended as a lower and upper bound, but represent 2 different possible budget outcomes.

The Baseline scenario uses the 4-sector 6% average revenue growth and incorporates the mandatory components of the federal health care expansion, but continues the current freeze on AHCCCS childless adult coverage.

- In this Baseline scenario, the state would have a short term balance of $676 million in FY 2013 that would decline to $368 million in FY 2014 with the expiration of the temporary 1 cent sales tax. By FY 2016, the state would run a small shortfall of $(67) million.

In the alternative scenario, revenues would grow by 5% and the state would opt to restore childless adult coverage at 100% and continue the DES backfill and state employee pay initiatives permanently.

- The Alternate scenario spends the balance down more quickly to $227 million by the end of FY 2014. There would be shortfalls in both FY 2015 and FY 2016 with the 2-year gap totaling $(994) million.

These balance estimates do not include $450 million in the state's Budget Stabilization Fund (otherwise known as the Rainy Day Fund).

Table 4 summarizes the FY 2013 – FY 2016 ending balance projections:

Table 4

Ending Balance Projections

	Fiscal Year			
Baseline Scenario	**13**	**14**	**15**	**16**
Beginning Balance	$ 0.4 B	$ 0.7 B	$0.4 B	$ 0.1 B
On-Going Revenues	9.0 B	8.4 B	8.8 B	9.2 B
Spending	8.7 B	8.7 B	9.1 B	9.4 B
Ending Balance	$676 M	$368 M	$66 M	$(67) M
Alternate Scenario				
Beginning Balance	$ 0.4 B	$ 0.7 B	$ 0.2 B	$ (0.4) B
On-Going Revenues	9.0 B	8.3 B	8.7 B	$9.0 B
Spending	8.7 B	8.8 B	9.3 B	$9.6 B
Ending Balance	$676 M	$227 M	$(411) M	$(994) M

Attachment A

October 2012 FAC Forecast
FY 2013 - FY 2016

	FY 2013	FY 2014	FY 2015	FY 2016
Sales Tax				
JLBC Forecast	5.0%	5.4%	5.5%	5.6%
UA - Low	2.0%	3.5%	5.7%	8.0%
UA - Base	5.1%	6.6%	8.2%	9.0%
FAC	5.5%	6.0%	5.1%	5.3%
Average:	**4.4%**	**5.4%**	**6.1%**	**7.0%**
Individual Income Tax				
JLBC Forecast	5.1%	6.2%	6.5%	6.5%
UA - Low	0.4%	1.3%	3.0%	4.7%
UA - Base	6.9%	5.6%	6.6%	7.0%
FAC	7.2%	7.4%	5.6%	6.1%
Average:	**4.9%**	**5.2%**	**5.5%**	**6.1%**
Corporate Income Tax				
JLBC Forecast	3.8%	3.7%	4.0%	6.0%
UA - Low	-6.7%	13.4%	1.4%	0.1%
UA - Base	15.9%	18.2%	5.6%	1.0%
FAC	8.7%	7.8%	7.1%	5.7%
Average:	**5.4%**	**10.9%**	**4.7%**	**3.2%**
JLBC Weighted Average:	**4.9%**	**5.6%**	**5.8%**	**6.0%**
UA Low Weighted Average:	**0.6%**	**3.4%**	**4.2%**	**6.1%**
UA Base Weighted Average:	**6.8%**	**7.3%**	**7.3%**	**7.5%**
FAC Consensus Weighted Average:	**6.5%**	**6.8%**	**5.5%**	**5.7%**
"Big-3" Weighted Average:	**4.7%**	**5.8%**	**5.7%**	**6.3%**
Consensus Weighted Average: *	**4.3%**	**5.8%**	**5.7%**	**6.3%**
Adj. Consensus Weighted Average: **	**3.2%**	**5.2%**	**4.2%**	**5.2%**

* Consensus Big-3 Categories adjusted for Small Categories

** Consensus Weighted Average adjusted for Tax Law Changes