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## Finance Advisory Committee

### Revenue and Budget Update

September 29, 2010

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### Summary of the Current Budget Status

#### Still Weak – But Better Than Last Year

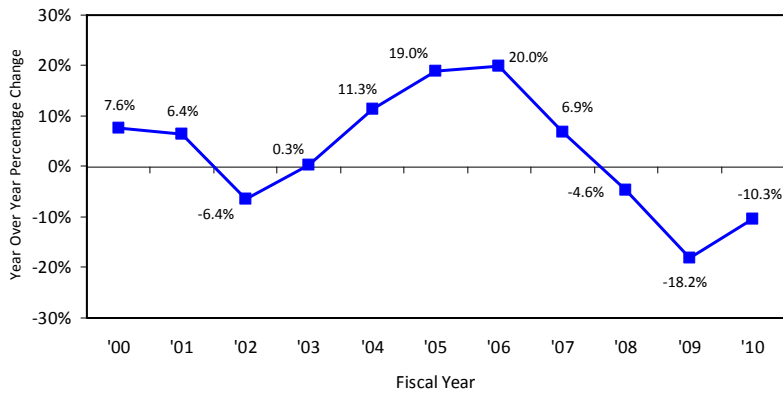
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- ❑ FY '10 revenues declined by (10.3)% - unprecedented 3<sup>rd</sup> consecutive year of decline
- ❑ April through September revenues, however, have grown slightly
- ❑ FY '11 base revenues forecasted to grow 2.4% in FY '11 followed by 4.8% in FY '12
- ❑ FY '11 shortfall estimated at up to \$(825) M followed by \$(1.4) B in FY '12 – excludes more than \$1 B in suspended funding formulas
- ❑ Federal restrictions may limit spending options to reduce shortfall, especially in FY '11

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**FY '10 Base Revenues Were (10.3)% Below FY '09**  
**- Unprecedented 3 Year Decline of (33)%**

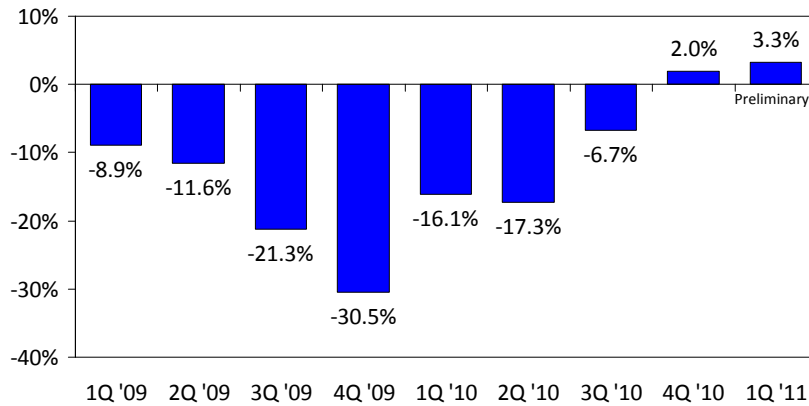


Excludes statutory and one-time changes.

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**There Has Been Some Good News**  
**- First Positive Quarterly Growth Since 1<sup>st</sup> Quarter of FY '08**



Base Revenues Percent Change From Prior Year  
 \*Excludes urban revenue sharing and one-time revenues

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## While 1<sup>st</sup> Quarter FY '11 Revenues Will Grow, the Rebound is Uneven and Volatile

- July and August are Final, September is Preliminary Projection

	% Change over 1 <sup>st</sup> Qtr. FY '10
Sales Tax	-3.5%
Individual Income Tax	6.5%
Corporate Income Tax	49.9%

- ❑ Due to poor sales tax performance, projected 1<sup>st</sup> quarter revenues are \$(44) M below forecast

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## The Road to Recovery Will Still Be Long

- ❑ 335,000 jobs lost since December 2007
  - Summer is high-water mark due to seasonal lay-offs
  - 28% of lost jobs were in construction
- ❑ Housing problems persist
  - While pending Valley foreclosures declined from 51,000 in December, there are still 41,318 in the pipeline
  - 50% of Arizona-wide mortgages “underwater”

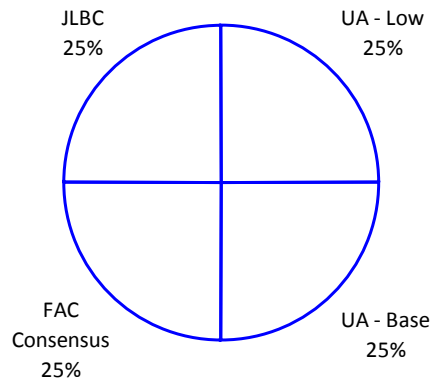
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## Where Are We Headed Over the Next Few Years? - Four-Sector Consensus Forecast Incorporates Different Economics Views, Including the FAC

4-sector forecast equally weights:

- FAC average
- UofA model – base
- UofA model – low
- JLBC Staff forecast
- Remaining revenues (10% of total) are staff forecast

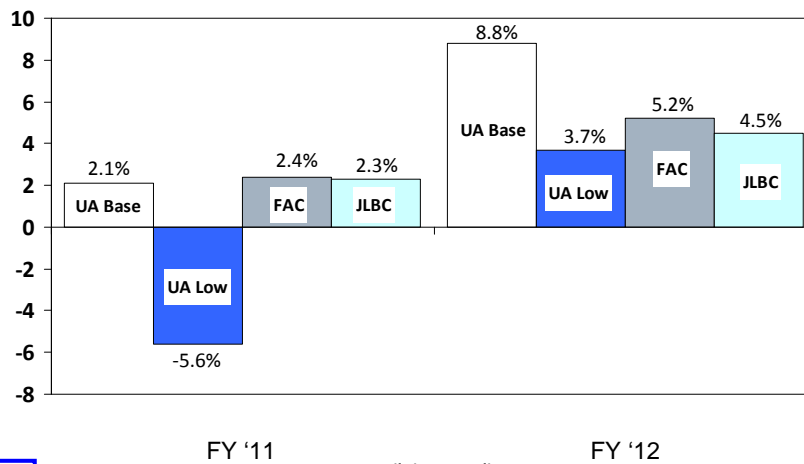


\* Includes Big 3 categories of sales tax, individual income and corporate income taxes

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## 4-Sector Projections Average 0.6% in FY '11 and 4.8% in FY '12\*



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Details in Appendix A

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\* Weighted Big 3 average growth prior to 1 ¢ sales tax, other changes, and adjusted for small categories.

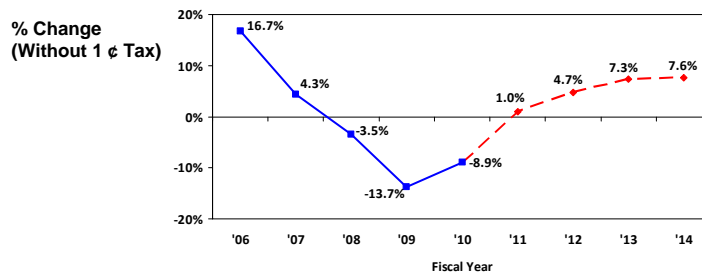
## Given Year-to-Date Data, Recommend Using 2.4% FY '11 Growth Rate

- ❑ Base Revenues would need to grow 5.1% in FY '11 to meet budgeted level
- ❑ With 3.3% 1<sup>st</sup> Quarter Growth, 0.6% FY '11 forecast maybe low
  - (5.6)% loss in UA Low forecast is unlikely. Average of other 3 sectors, adjusted for small categories, is 2.4%
  - New withholding tables may cause volatility
- ❑ 2.4% growth would result in \$206 M revenue shortfall
  - Compares to projected 1<sup>st</sup> quarter loss of \$(44) M
- ❑ FY '12 forecasts vary from 3.7% to 8.8%

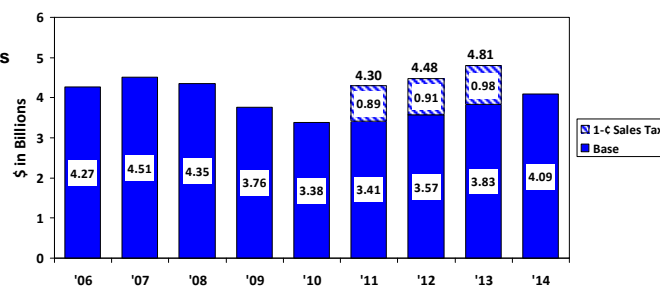
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## Sales Tax



General Fund Dollar Collections



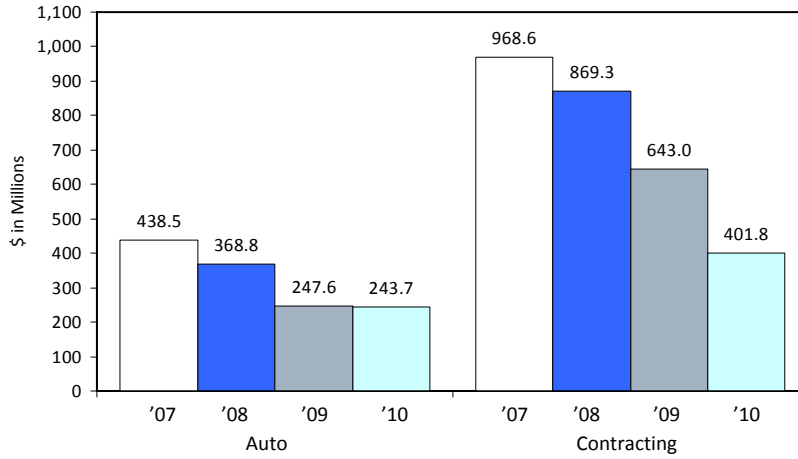
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Without tax law changes, FY '07 would be 5.6% and FY '10 would be (10.1)%.

## Vehicle Spending Appears to Have Stabilized, Contracting Continues Sharp Decline

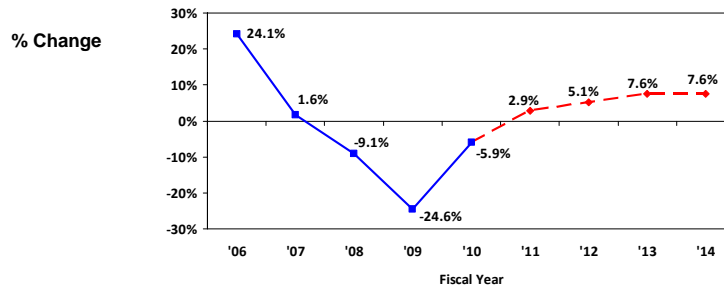
- Fiscal Year Sales Tax Collections



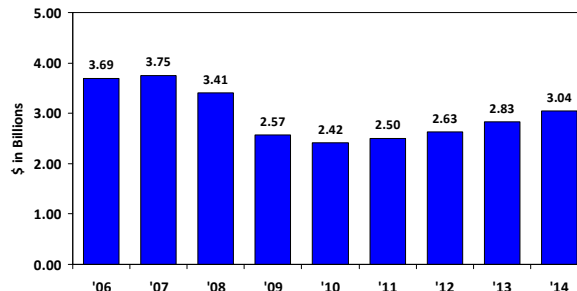
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## Individual Income Tax



General Fund  
Dollar Collections



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Without tax law changes, growth would have been 6.3% in FY '07 and (4.1%) in FY '08

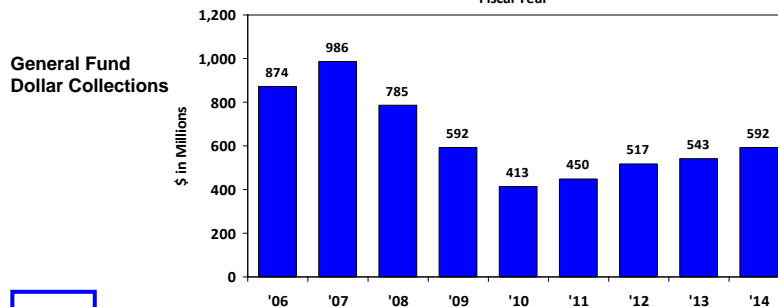
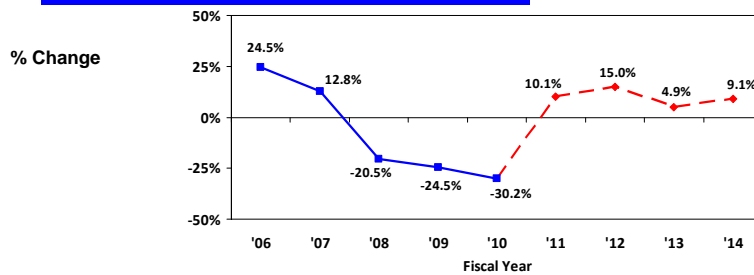
## New Withholding Table Complicates Analysis of Revenue Changes

- ❑ Revised state withholding rates cut link to Federal withholding
- ❑ Difficult to ensure the same level of withholding when rates have changed
- ❑ Through almost 3 months, withholding has increased 3.1%
- ❑ Will not know if withheld correct amount until April tax filing

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## Corporate Income Tax



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Without tax law changes, baseline growth for FY '08 – FY '10 would be (17.2%), (20.7%), and (18.7%), respectively.

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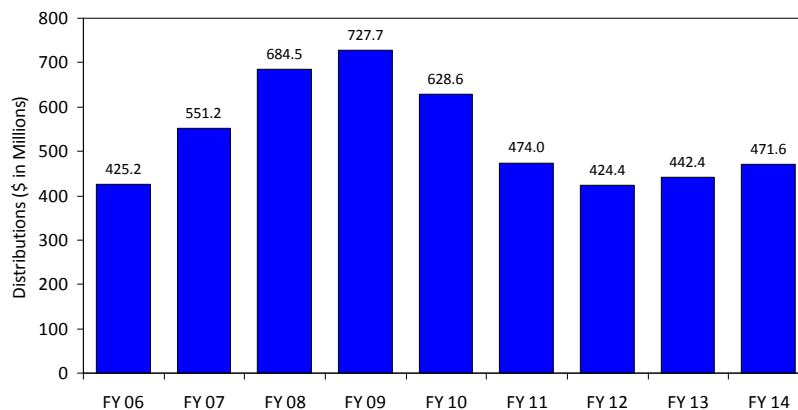
## Corporate Could Experience Large % Gain in FY '11

- ❑ Increased corporate profitability would likely increase collections
- ❑ September quarterly payments \$40 M above last year
- ❑ Possible gain in November if do not refund \$70 M again

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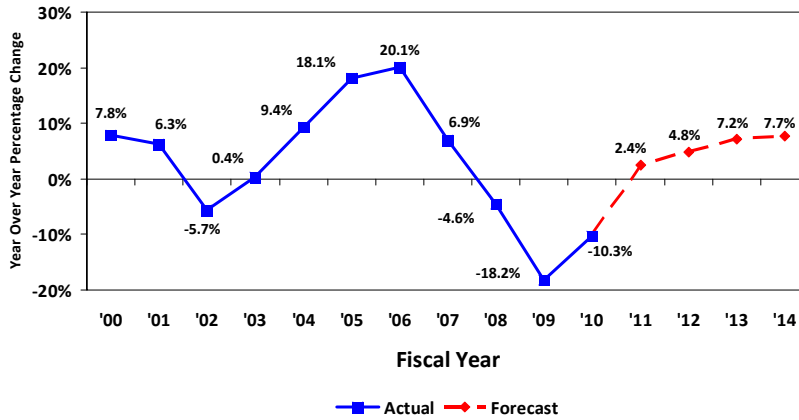
## Income Tax Revenues Determine Urban Revenue Sharing



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## Consensus Forecasts 7% to 8% Growth in FY '13 & FY '14

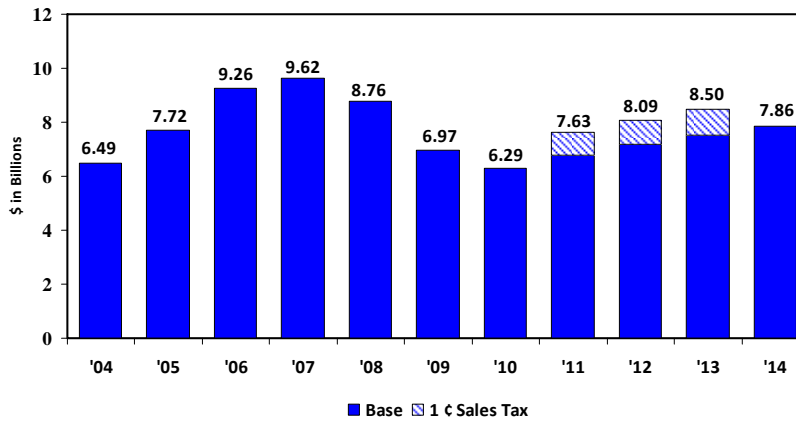


\* Adjusted for small revenue categories in '11 & '12

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## Even With 1 ¢ Sales Tax, General Fund Base Revenues Would Be Below '07 Level Through '14



- Excludes balance forward and other one-time revenues

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## How Does New Forecast Affect Budget Shortfall?

### **FY '11 Shortfall Could Be Up to \$(825) M**

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4 Potential Problems:

- Potential failure of November ballot props – \$469 M
- Lower Federal Matching Funds - \$158 M
- Possible revenue shortfall with new forecast – \$206 M
- \$100 M K-12 shortfall – offset with federal funds

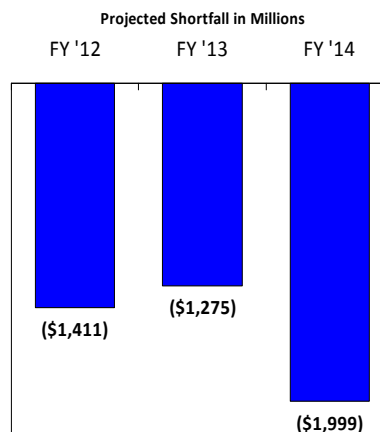
**Baseline FY '12 Spending is Projected to Grow \$900 M**  
**- Represents Funding of Active Formula Requirements**

- ❑ Most of the growth due to elimination of one-time federal assistance for Medicaid and K-12
- ❑ K-12 and AHCCCS normal formula growth expected to be relatively limited
  - Population growth moderated
  - Assumes continuation of limited inflation policy
- ❑ SFB debt service requirements will increase \$94 M due to one-time FY '11 savings

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**State Budget Has A Projected Cash Shortfall**  
**- Any Permanent Solutions in FY '12 Reduce FY '13 and FY '14 Gaps**

- ❑ Based on consensus revenues and active formula growth
- ❑ FY '12: Federal assistance expires
- ❑ FY '14: Sales tax would expire and increase shortfall



Assumes Prop 302 Passes – Shortfall \$80 M Higher If It Fails

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## Restating Arizona's Main Budget Problem in FY '12

Revenues = \$8.2 B

Spending = \$9.6 B

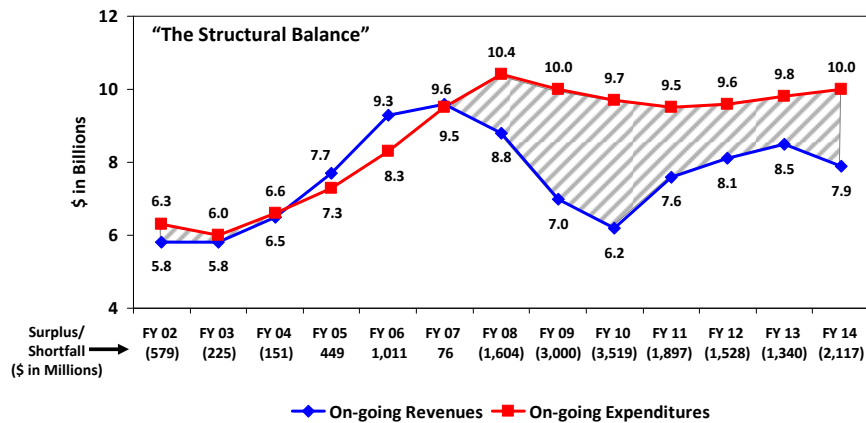
- This estimate does not include \$1.4 B of currently suspended funding formulas – (Appendix B)

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## Structural Gap Comparable to Cash Gap Starting in FY '12

- Represents On-Going Revenues Versus On-Going Expenditures



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## Besides Cash Balance, There Are 2 More Measures of State's Fiscal Condition

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- ❑ Operating Fund Balance – the “checkbook”
  - Operating fund positive since Mid-June – no outside borrowing
  - Anticipated to remain positive in at least the near-term
  
- ❑ State's Credit Rating
  - Downgraded in July to 5<sup>th</sup> of 10 investment grades
  - Downgrade due to economic weakness, structural imbalance, and constitutional limits
  - Outlook shifted from “negative” to “stable,” but rating lower than most other states

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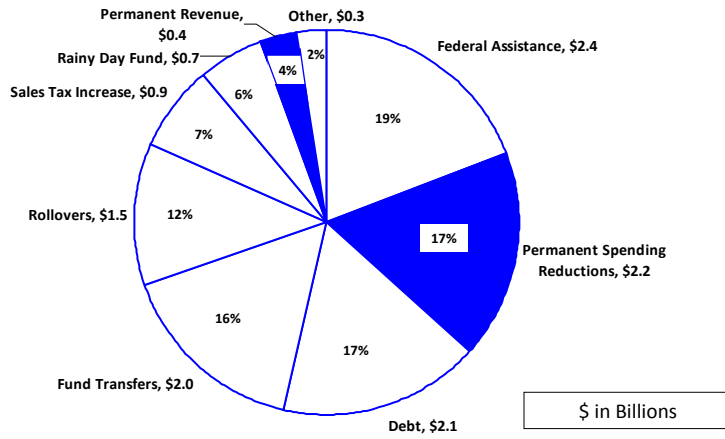
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## Where Do We Go From Here?

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**Since FY '08, State Has Used Mostly Temporary Solutions to Resolve Budget Shortfalls**  
**- \$12.5 B In Cumulative Solutions**



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Budget solutions as share of shortfall

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**While Permanent Solutions Remain Preferable, One-Time Options Are Still Available**  
**- But Usually at Lower Levels**

- Rollovers
- Debt Service Payment Holidays
- Fund Sweeps
- Asset Sales and Leasebacks

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## Federal Maintenance of Effort (MOE) Requirements May Limit State's Flexibility

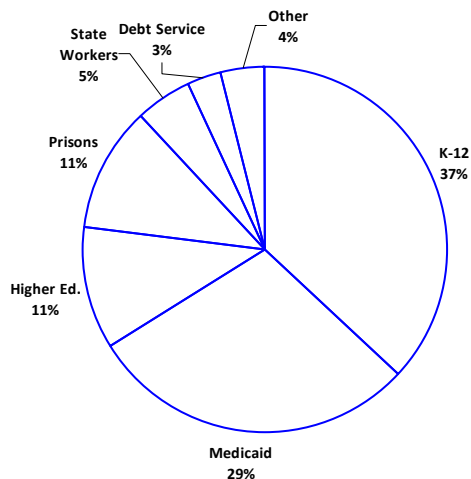
- ❑ Federal health care legislation prevents state from changing most Medicaid eligibility
  - Changes could result in loss of \$7 B in federal matching
  - Can still modify rates at any time
  
- ❑ Federal education stimulus prevents state from reducing spending below FY '06 level
  - K-12 and Higher Education already at FY '06 level
  - Requirement expires at end of FY '11

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## 6 Major Activities Account For 96% of On-Going General Fund Spending - Education and Medicaid Represent 77%

Unit	(Millions)
Education (K-12)	\$ 3,559.1
Medicaid	2,749.7
Higher Education	1,025.5
Prisons	1,005.7
State Workers	509.0
Debt Service	292.4
Other	<u>422.9</u>
<b>TOTAL</b>	<b>\$ 9,564.3</b>



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## Appendix A: September 2010 4-Sector Forecast

	FY 2011	FY 2012	FY 2013	FY 2014
<b>Sales Tax</b>				
JLBC Forecast	1.0%	4.3%	7.3%	6.7%
UA – Low	-5.1%	2.7%	6.3%	8.3%
UA – Base	-1.7%	7.2%	9.2%	9.3%
FAC	1.9%	4.7%	6.2%	6.3%
Average:	-1.0%	4.7%	7.3%	7.6%
<b>Individual Income Tax</b>				
JLBC Forecast	2.9%	4.4%	6.3%	6.8%
UA - Low	-6.6%	3.3%	8.0%	8.7%
UA – Base	6.5%	7.5%	9.4%	8.9%
FAC	3.2%	5.0%	6.8%	6.0%
Average:	1.5%	5.1%	7.6%	7.6%
<b>Corporate Income Tax</b>				
JLBC Forecast	10.1%	6.3%	10.2%	16.2%
UA – Low	-3.6%	14.4%	-1.7%	6.0%
UA – Base	7.9%	28.0%	-1.4%	3.7%
FAC	1.4%	11.2%	12.4%	10.4%
Average:	4.0%	15.0%	4.9%	9.1%
JLBC Weighted Average:	2.3%	4.5%	7.1%	7.5%
UA Low Weighted Average	-5.6%	3.7%	6.4%	8.3%
UA Base Weighted Average	2.1%	8.8%	8.4%	8.7%
FAC Weighted Average:	2.4%	5.2%	6.9%	6.5%
Consensus Weighted Average:	0.6%*	4.8%*	7.2%	7.7%

\* Consensus forecast adjusted for small tax categories

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## Appendix B: Funding Formula Suspensions for FY 2011

### Statutory Funding Formula Suspensions for FY 2011

Agency	Formula	Savings
Community College	Operation and Equalization Formula	\$7,486,100
	Capital State Aid Suspension	\$20,652,500
Department of Education	Soft-Capital Formula	\$165,120,700
	New Utilities Formula	\$100,000,000
	Charter School Additional Assistance	\$10,000,000
Department of Emergency & Military Affairs	Military Installation Fund Deposit	\$2,800,000
	Governor's Emergency Fund	\$2,100,000
Department of Environmental Quality	WQARF	\$8,000,000
Judiciary	Probation Revocation Payment	\$2,410,300
School Facilities Board	Building Renewal	\$231,715,400
Tourism	Tourism Funding Formula	\$14,613,300
State Treasurer	Justice of the Peace Salaries	\$1,115,000
Universities	Financial Aid Trust	\$2,797,800
Department of Water Resources	Water Protection Fund Transfer	\$5,000,000
Subtotal		\$573,811,100
Future Year Cost – Department of Education	Teacher Performance Pay (by FY 2018)	\$278,000,000
Future Year Cost – School Facilities Board	New School Construction (If enrollment returns to pre-recession level)	\$386,000,000
Total		\$1,237,811,100

### Non-Statutory Formula Suspensions for FY 2011

Department of Administration	Building Renewal	\$33,400,000
Universities	Enrollment	\$32,390,800
	Building Renewal	\$88,957,100
Subtotal		\$154,747,900

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