
Finance Advisory Committee

Revenue and Budget Update

October 5, 2016

JLBC

Summary of Current Budget Status

- ❑ The October Baseline estimate provides an updated forecast of General Fund revenues and statutory spending
- ❑ Over the next 2 years, base revenue growth is projected to remain near 4%
- ❑ '18 Baseline spending growth is expected to be flat – largely due to the elimination of \$200 M of one-time '17 spending
- ❑ The projected '18 cash balance is \$101 M, but the structural balance is only \$24 M
- ❑ Prior to any discretionary '18 changes, '19 cash and structural balance are both projected at \$146 M

Key Elements In Constructing An '18 Budget

- ❑ Decision 1: Is structural balance an '18 budget goal?
- ❑ Decision 2: What is the target for the State's level of reserves?
 - Reserves represent the cash balance plus the Budget Stabilization Fund
 - The BSF has a \$460 M balance, or 4.8% of the '18 budget. The statutory cap is 7%.
 - When adding the \$101 M Baseline cash balance, total reserves would be 5.8% of the '18 budget

Recommended Reserve Benchmarks

- ❑ The conventional standard has been 5% of a state's budget
- ❑ Moody's Rating Agency has the following guidelines:
 - Aaa Standard = Reserves exceed 10%
 - Aa1 Standard = Reserves 5% to 10%
 - Aa2 Standard = Reserves 0% to 5%
- ❑ Arizona currently has a Aa2 rating in general
 - Higher reserves would not guarantee a higher rating as it is only one of several factors considered by rating agencies.
- ❑ Standard and Poor's gives the highest score to states with balances above 8%.

The State's Reserves Protect Against Risks

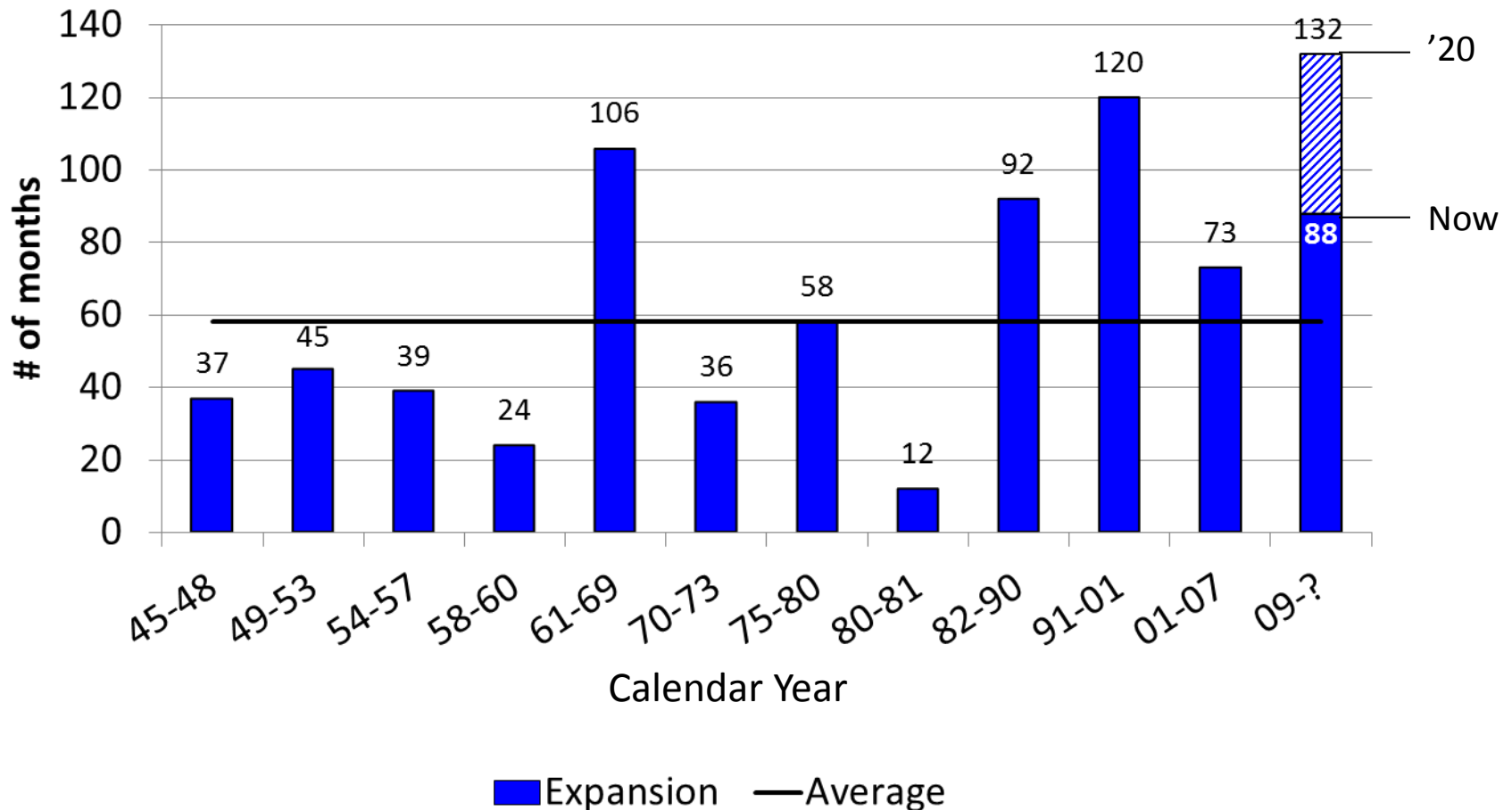
- ❑ 1% Variance in revenue estimates yields \$625 M over 3 years – exceeds current reserves
- ❑ Conflicting economic signals generates revenue uncertainty
- ❑ Pending litigation could significantly affect spending

Forecast Risks – Conflicting Economic Signals

- ❑ Generally improving job market both in Arizona and US - but underemployment levels remain high
- ❑ Housing construction is up in Arizona, but not envisioned to return to pre-recession average
- ❑ Slow US GDP growth - may have inhibited some interstate migration
- ❑ Low oil and gas prices continue to help the economy outside of the energy states
- ❑ Major uncertainties:
 - Federal Reserve Board interest rate policy
 - US presidential election
 - Length of current recovery

Current Expansion Exceeds Historical Average

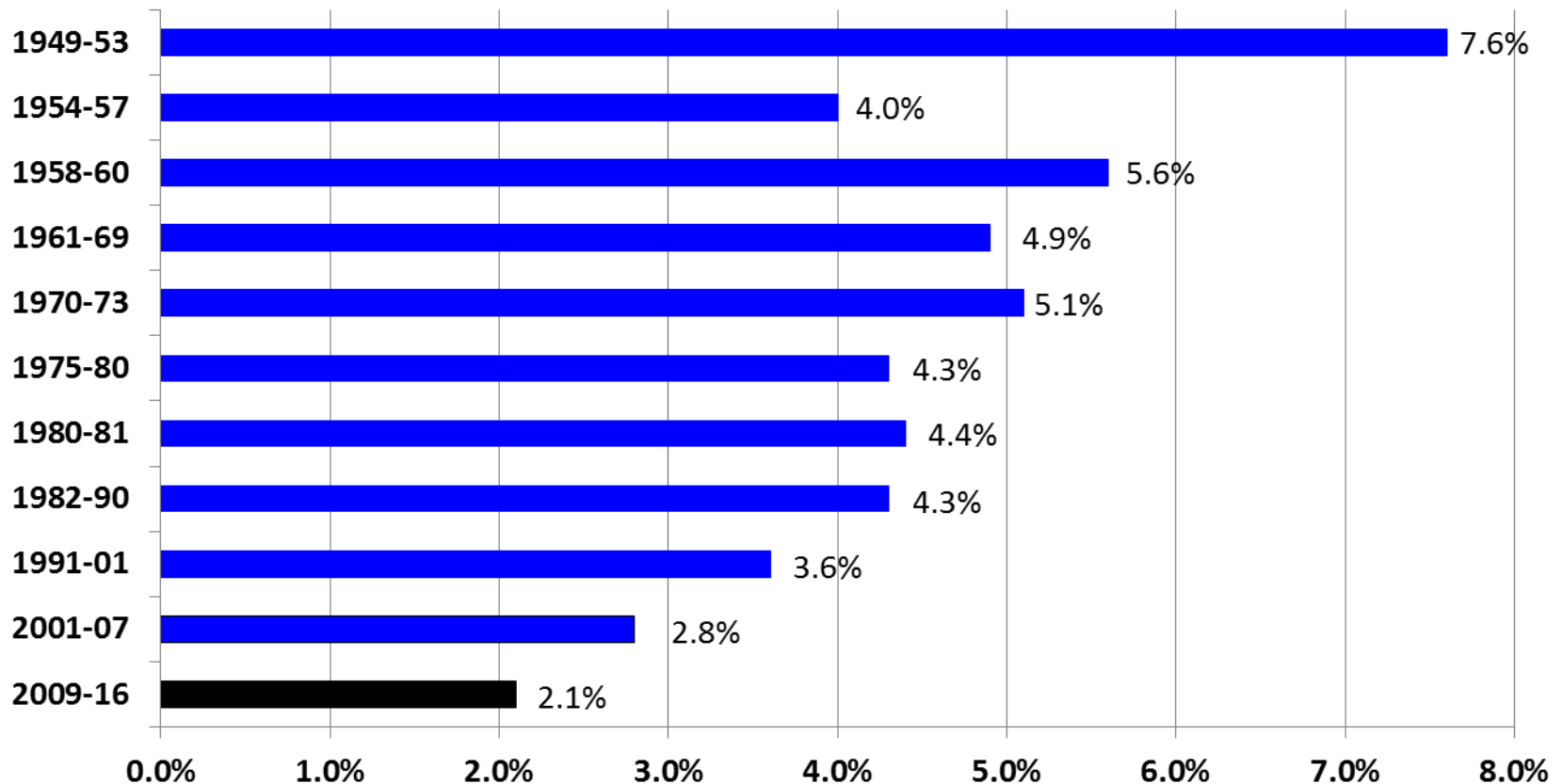
Length of US Economic Expansions



Current Recovery is Weakest in Post WWII Economy

- May Permit Longer Expansion

Average Real GDP Growth During Each Expansion



Forecast Risks – Pending Litigation

- ❑ Hospital assessment litigation – If the appellate courts rule that the Medicaid assessment required 2/3rds vote, the State would lose \$250 M from that funding source.
- ❑ Rental car surcharge litigation – Superior Court ruling limits the car rental tax to transportation rather than for stadium subsidies. Potential cost of \$150 M.
- ❑ Foster care litigation – The State is currently being sued in Federal Court over inadequate foster care services. Too early to estimate a potential cost.

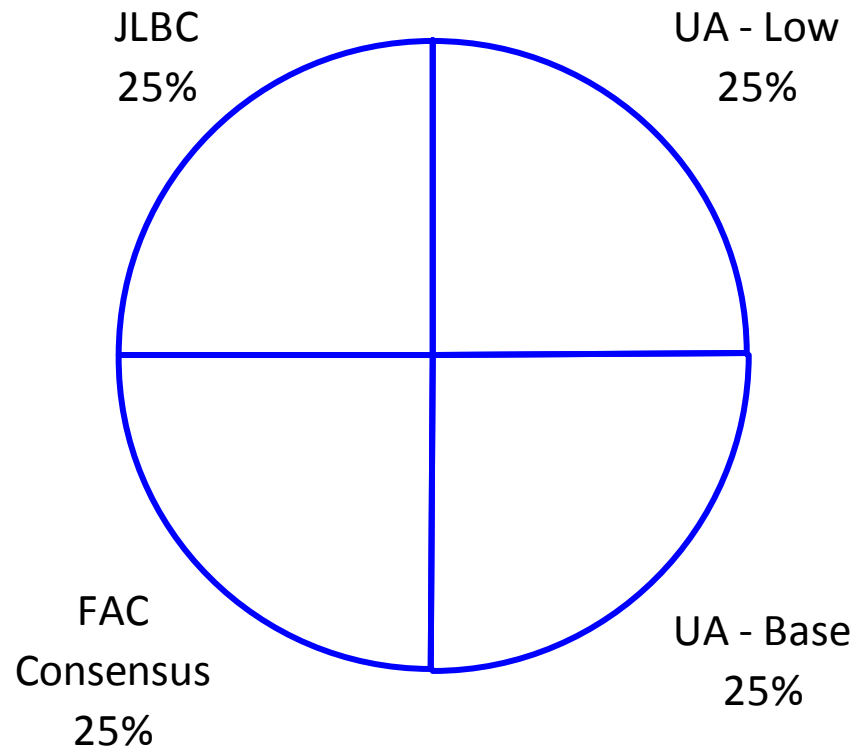
Revenue Forecast

Where Are We Headed Over the Next Few Years?

- Four-Sector Consensus Forecast Incorporates Different Economic Views, Including the FAC

4-sector forecast* equally weights:

- ☐ Finance Advisory Committee
- ☐ UofA model – base
- ☐ UofA model – low
- ☐ JLBC Staff forecast
- ☐ Remaining revenues (5%) are JLBC Staff forecast



* Includes Big 4 categories of sales tax, individual and corporate income taxes, and insurance premium taxes

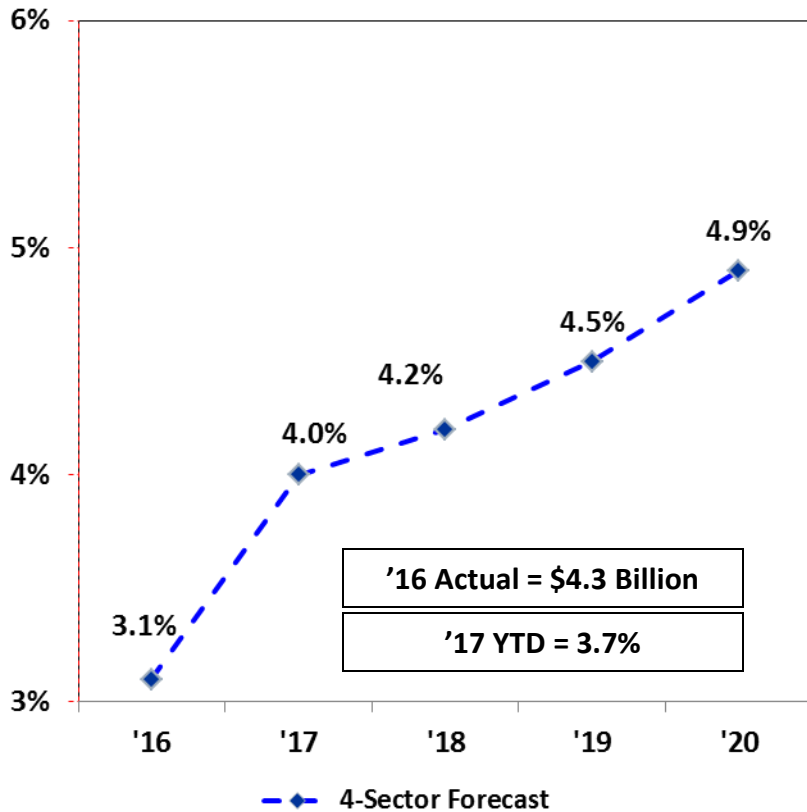
'17 YTD Continues Slow '16 Revenue Growth

	<u>'16 Actual</u>	<u>'17 YTD</u>
Sales	2.9%	3.7%
Individual Income	5.5%	4.0%
Corporate Income	(13.9)%	(31.3)%
Insurance Premium	9.9%	12.6%
Other	11.1%	134.0%
Overall	3.5%	3.5%

- ❑ Includes preliminary September estimates
- ❑ Revenues exclude fund transfers and urban revenue sharing
- ❑ Through September, year-to-date revenues \$18 M above forecast

Sales Tax

- Projected Growth of 4.0% in '17 and 4.2% in '18



Percent Change in Base Revenue Excluding
Statutory Changes and 1-Cent Sales Tax

- ❑ '16 was lowest growth since '11
- ❑ Overall US retail sales growth is slowing
- ❑ E-Commerce doubled over the last 5 years

'16 Sales Tax Growth by Category

	'16 Growth by Category	
Retail	5.6%	<input type="checkbox"/> TPT shifted from contracting to retail in 2015
Contracting	(10.0)%	
Use	0.8%	<input type="checkbox"/> Magnitude of shift cannot be determined
Restaurant/Bar	5.5%	
Utilities	1.7%	<input type="checkbox"/> Contracting decline likely caused by shift
Other	3.3%	
Total	2.9%*	

*Reflects net growth after tax law changes

TPT Simplification Revenue Impact

- JLBC Staff Statutorily Required Report

(\$ Millions)

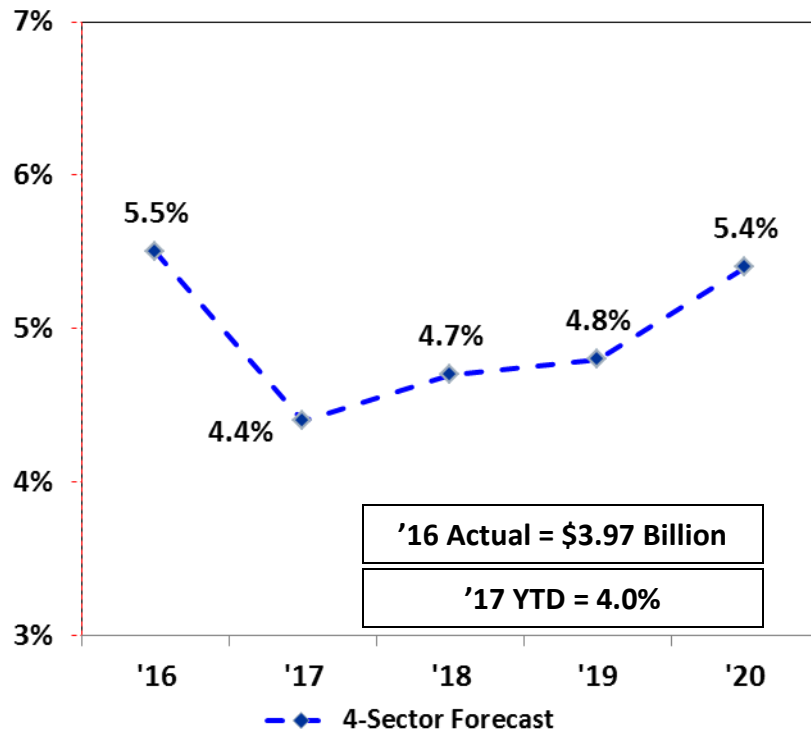
<u>Chapter 255 Provisions</u>	<u>General Fund Revenue</u>	<u>County-Shared Revenue</u>	<u>City-Shared Revenue</u>	<u>Total State Sales Tax</u>	<u>County Excise Taxes</u>
Eliminate Contracting Tax on MRRA Projects*	\$(49.0)	\$(4.6)	\$(2.8)	\$(56.4)	\$(8.0)
Apply Retail TPT to MRRA Materials	\$23.4	\$5.2	\$3.2	\$31.8	\$4.4
Apply Use Tax to MRRA Materials	Small Gain	0	0	Small Gain	0
Eliminate Builder-Owner TPT	\$(4.3)	\$(0.4)	\$(0.3)	\$(5.0)	Unknown
Eliminate Nonresident Shipping Retail Exemptions	<div> <div>←</div> <div>Unknown Gain</div> <div>→</div> </div>				
Clarify Sourcing Statutes for Remote Sales	DOR originally estimated impact at \$25 M, but DOR now says it has no impact				
TOTAL**	<div> <div>←</div> <div>Unknown</div> <div>→</div> </div>				

*MRRA = maintenance, repair, replacement, or alteration of real property

****While some provisions can be roughly estimated, others cannot. As a result, adding only the provisions with an estimated impact would lead to a false conclusion concerning the bill's impact.**

Individual Income Tax

- Projected Growth of 4.4% in '17 and 4.7% in '18



- 5.2% withholding growth in second half of '16 reflects improving job market
- Payment growth slowed last 5 months of '16
- 2nd half of '16 trends are stronger YTD in '17

Percent Change in Base Revenue Excluding
Statutory Changes and One-Time Changes

YTD '17 Results Amplify Late '16 Trends

Percent Gain Above Prior Year		
	<u>'16</u>	<u>YTD '17</u>
Withholding	4.0%	6.5%
Payments	8.9%	(6.3)%
Refunds	4.6%	15.2%
Total	5.5%	4.0%

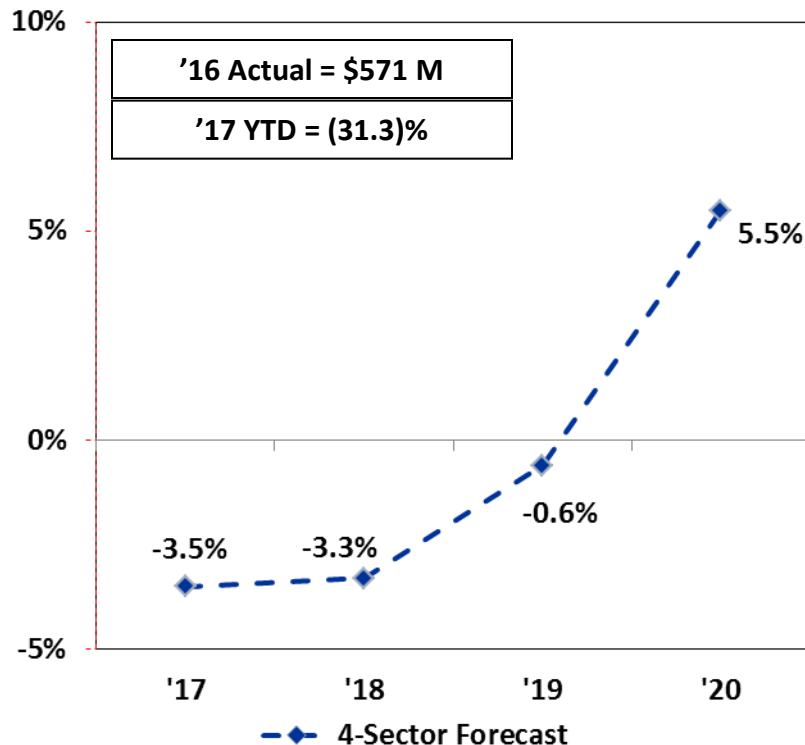
- ❑ 4% withholding in '16 highest since '11
- ❑ '17 YTD withholding growth accelerated to 6.5% — may be a timing issue
- ❑ '16 payment growth slowed from 24% in 1st 7 months to 1.1% last 5 months
- ❑ Payments declined (6.3)% in 1st Quarter

Will DOR Staffing Decision Reduce Revenues?

- ☐ DOR has reduced its collection/audit staff by one-third
- ☐ Revenue impact is unknown
- ☐ 78 FTEs and contracted collectors added in '11 were budgeted to increase revenue by \$53 M
- ☐ DOR says it is focusing on improving voluntary compliance
- ☐ Revenue forecast has not been significantly adjusted for the impact of this staff reduction

Corporate Income Tax

- Projected Decline of (3.5)% in '17 and (3.3)% in '18

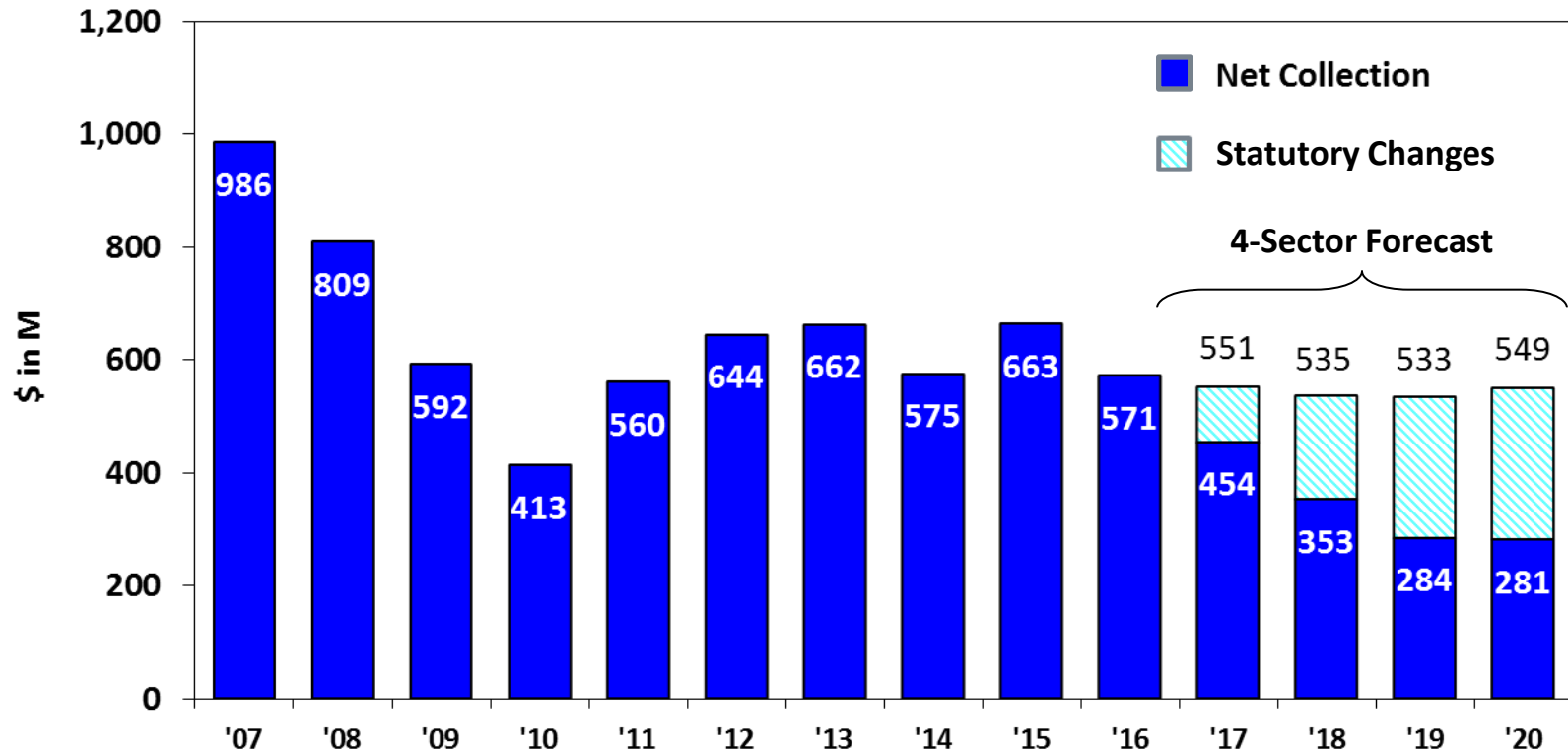


Percent Change in Base Revenue Excluding
Statutory Changes and One-Time Changes

- ❑ In 23 of last 29 years, annual change has been $> \pm 10\%$
- ❑ National before-tax profits have declined for 5 consecutive quarters
- ❑ Nationwide, state corporate tax collections declined in last 2 quarters

'20 CIT Projected to be \$281 M

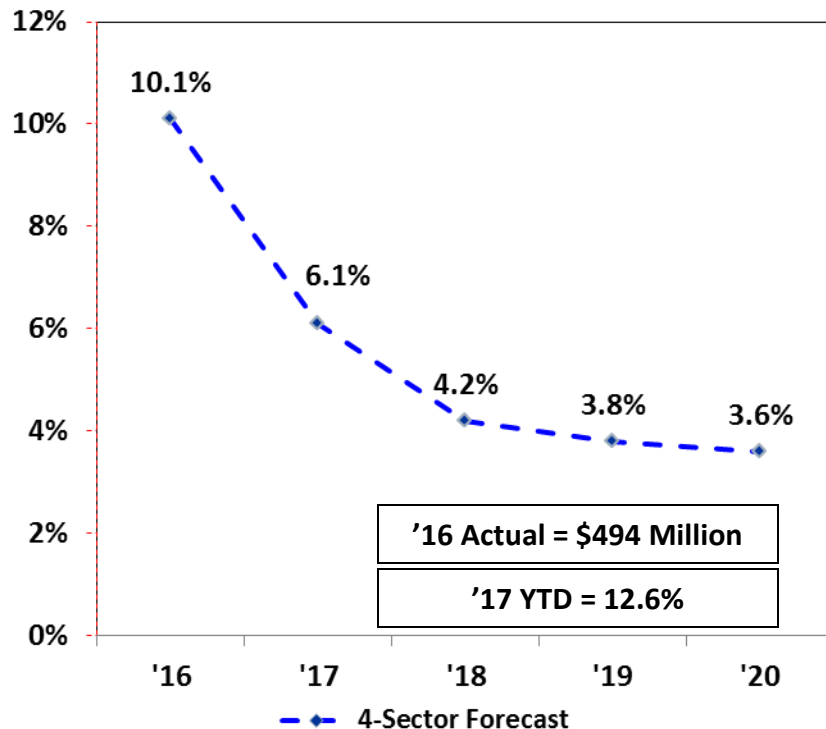
- Primary Reductions are 2% Rate Cut and 100% Sales Factor



Given taxpayer confidentiality, timing of tax reductions highly uncertain

Insurance Premium Tax

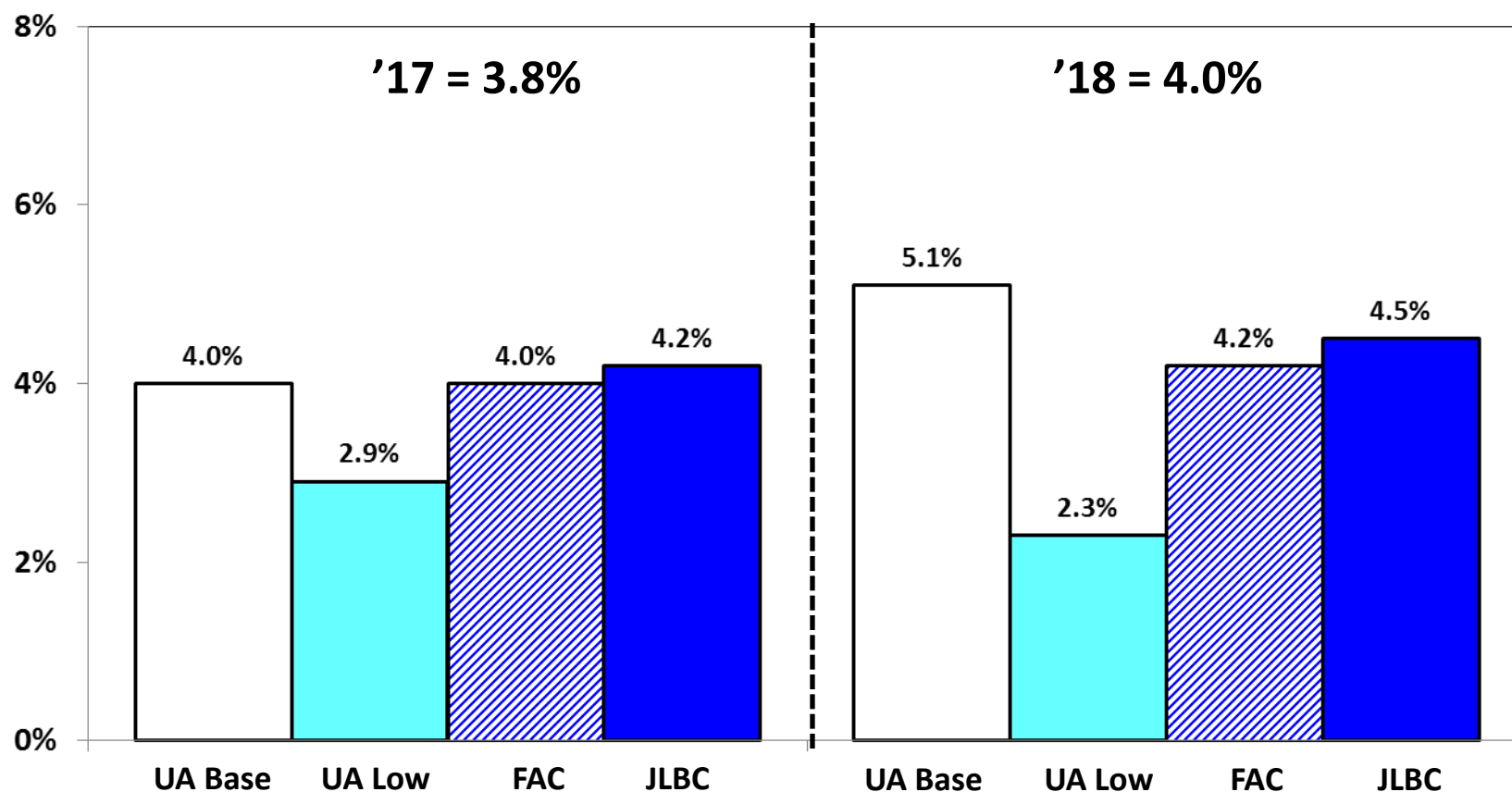
- Projected Growth of 6.1% in '17 and 4.2% in '18



- ❑ IPT (\$516 M) expected to exceed CIT (\$454 M) in '17
- ❑ As a result, IPT is now included in FAC and UA forecasts
- ❑ IPT grew 27.7% in total over last 3 years
- ❑ Federal AHCCCS expansion driving recent year increases

Percent Change in Base Revenue Excluding
Statutory Changes and One-Time Changes

4-Sector Base Growth is 3.8% in '17 & 4.0% in '18



Details in Appendix A

Prior to adjusting for small tax categories, the Big 4 base growth rate is 3.9% in '17 and 4.0% in '18

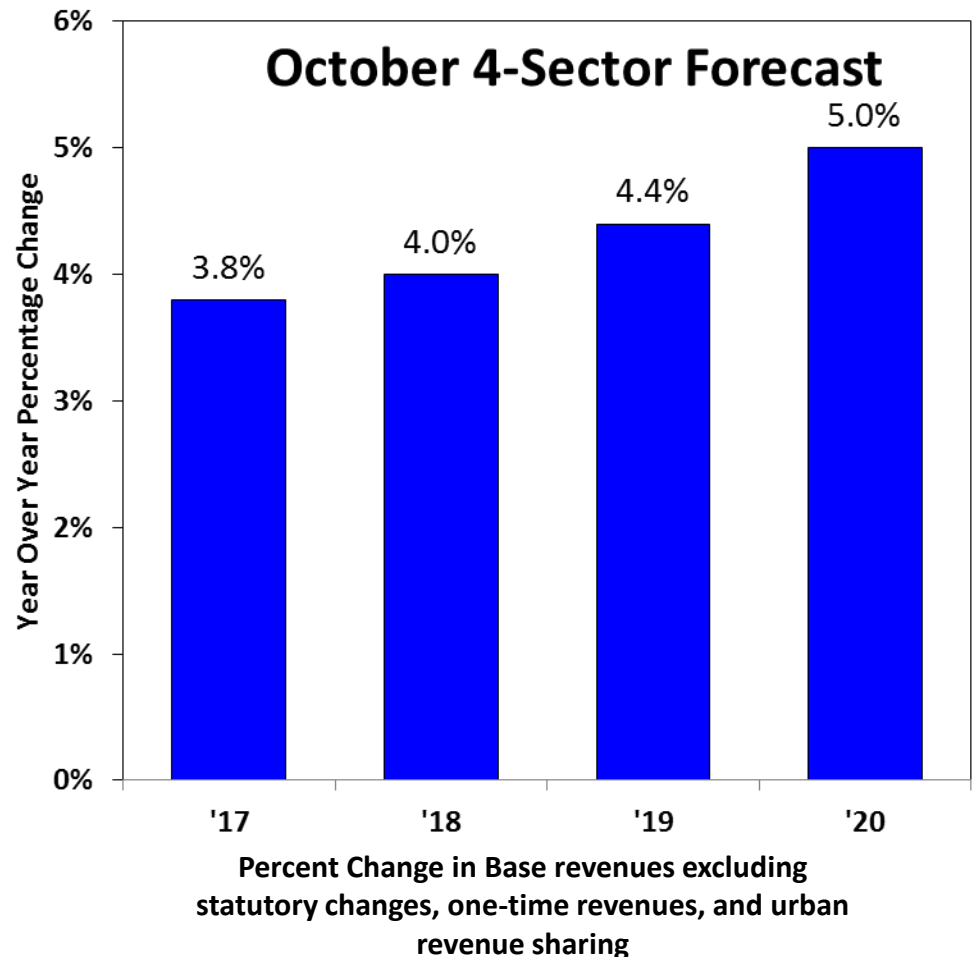
Growth Accelerates Through '20

Chance of Exceeding Forecast

65%

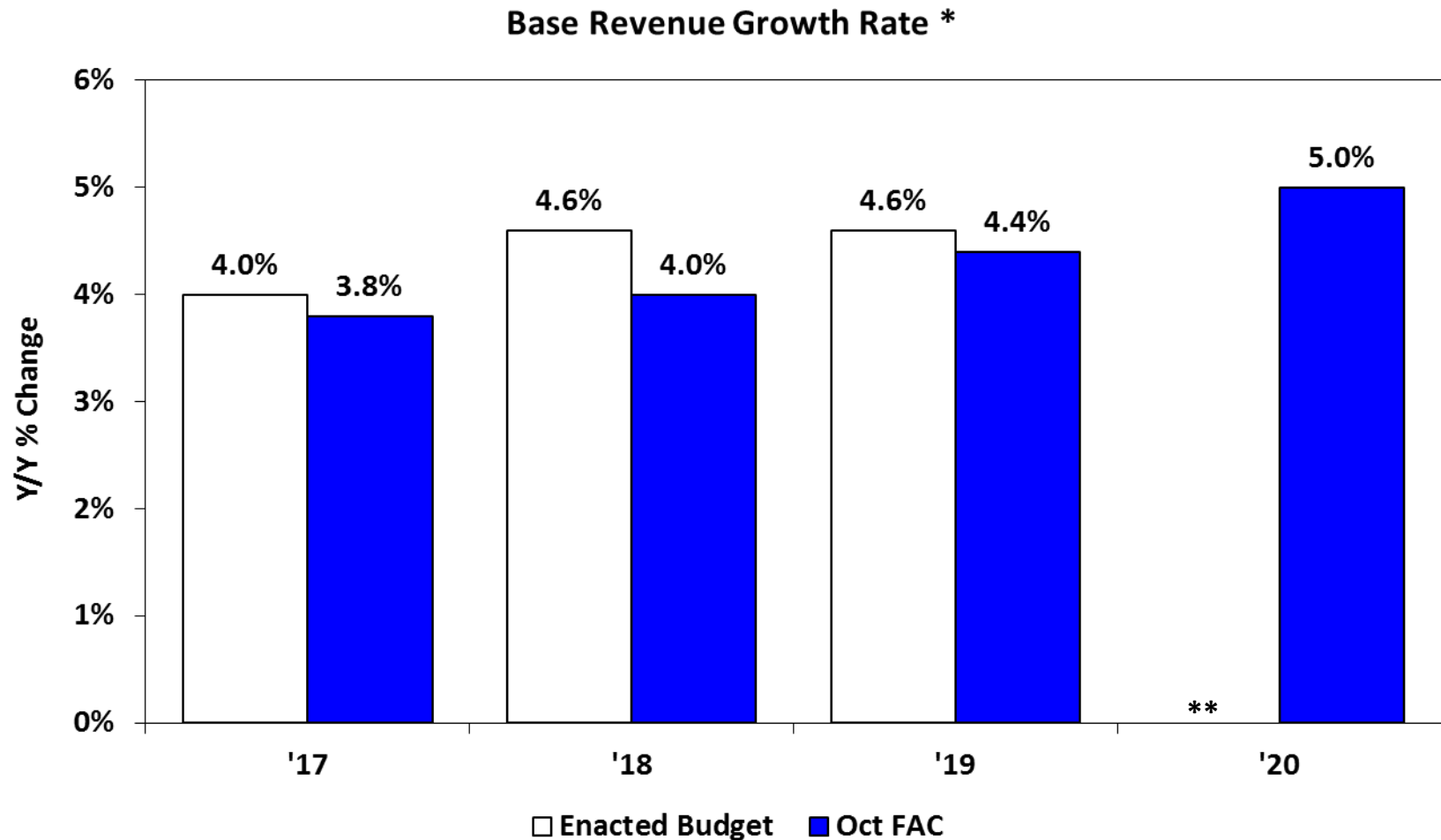
Long Run Average Growth

4.75%



Details in Appendix A

Current Forecast Versus Enacted Budget



*Excludes one-time revenues, tax law changes, and urban revenue sharing

** Enacted '17 budget did not include a '20 estimate

Components of the Revenue Forecast

- Excludes Change in Beginning Balance

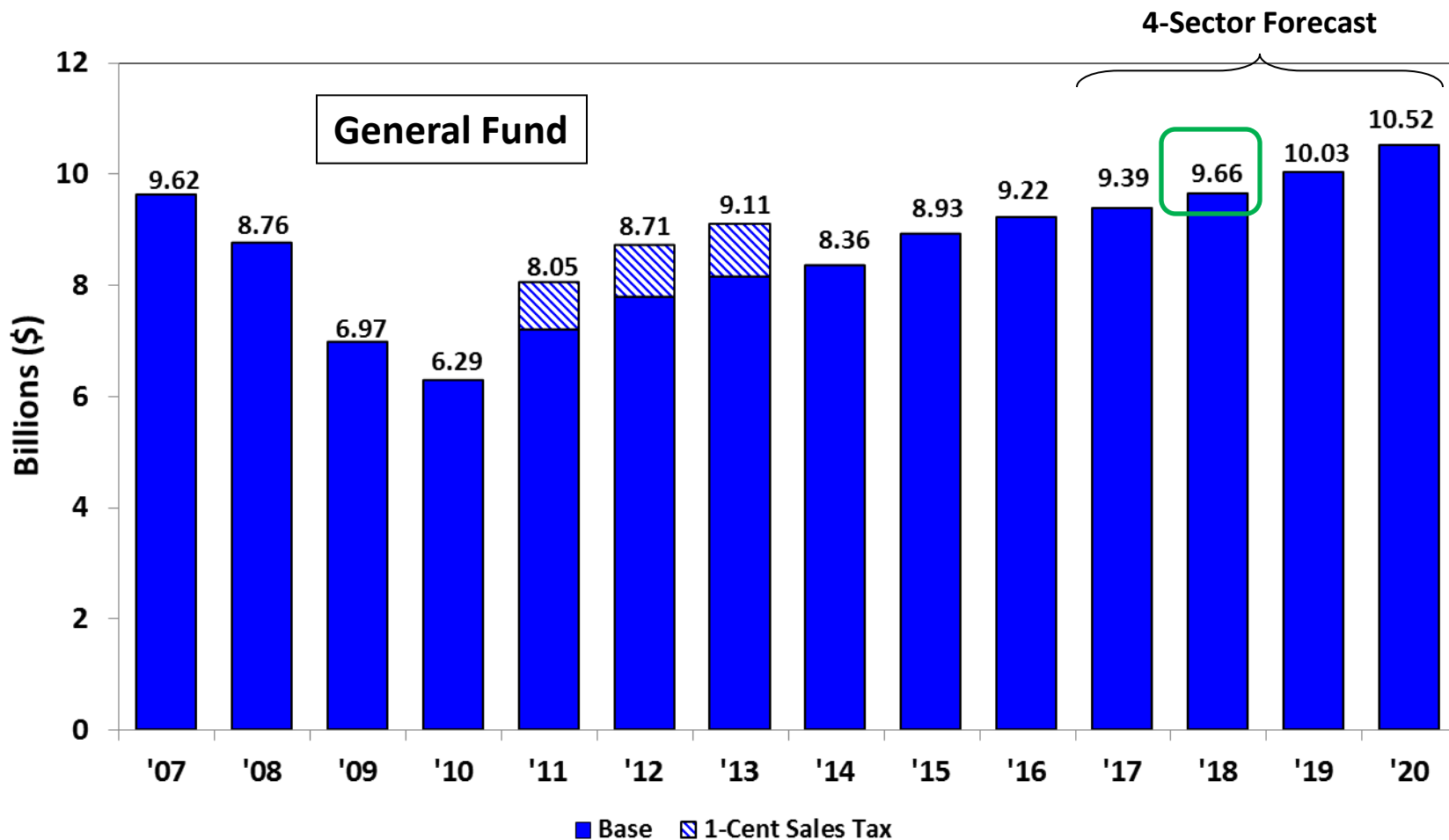
	\$ in M			
	<u>'17</u>	<u>'18</u>	<u>'19</u>	<u>'20</u>
Base Revenue Growth (3.8%/4.0%/4.4%/5.0%)	371	401	455	534
One-Time Fund Transfers	(141)	(79)	0	0
Remove '16 Tax Amnesty Revenues	(47)	0	0	0
Previously Enacted Tax Legislation	(135)	(119)	(78)	(31)
Urban Revenue Sharing	(58)	(12)	(7)	(13)
Total	(10)	191	370	490
% Change	(0.1)%	2.0%	3.8%	4.9%

Phase-In of \$228 M of Enacted Tax Reductions

	\$ in M*		
	<u>'18</u>	<u>'19</u>	<u>'20</u>
Corporate Rate Reduction/Sales Factor	(74)	(52)	(0)
Corporate/IPT School Tuition Indexing	(12)	(15)	(18)
Bonus Depreciation Full Conformity	(8)	(0)	(0)
Manufacturing Electricity Exemption	(12)	(0)	(0)
Other	<u>(13)</u>	<u>(11)</u>	<u>(13)</u>
Total	(119)	(78)	(31)

*By '20, revenue base is \$(228) M lower than in '17

Forecast Reaches Pre-Recession Level in '18



Excludes balance forward and other one-time revenues. Includes tax law changes and urban revenue sharing.

Spending Forecast

'17 – '20 Baseline Spending Projections

- ❑ Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- ❑ Continues annual suspension of \$493 M of inactive formulas
- ❑ Continues \$931 M in K-12 “rollover” payments
- ❑ Assumes spending classified as one-time or expiring in '17 budget does not continue
- ❑ Baseline excludes \$350 M in '18 discretionary increases requested by state agencies

Projected Spending Changes

- \$200 M In '18 Statutory Spending Offset By Elimination Of 1-Times

	\$ in M Above Prior Year		
	'18	'19	'20
K-12 – Formula	110	134	167
K-12 – Expiring Statutory Provisions	(43)	0	0
AHCCCS	60	118	144
DES	22	27	30
Corrections	7	1	2
Universities	(15)	0	(3)
DCS	0	0	0
SFB	(1)	(35)	32
DPS – Border Task Force Equipment	(15)	0	0
Counties – Cost Sharing Offset	(8)	0	0
Capital – \$8 M ADOA/\$10 M Vets Home	(18)	0	0
Capital – ADOT Highway Projects	(87)	0	0
Other	(11)	3	1
Total Spending Changes	1	248	373
Total Spending	\$9,639	\$9,887	\$10,260
% Change	0.0%	2.6%	3.8%

Projected Ending Balance Estimates

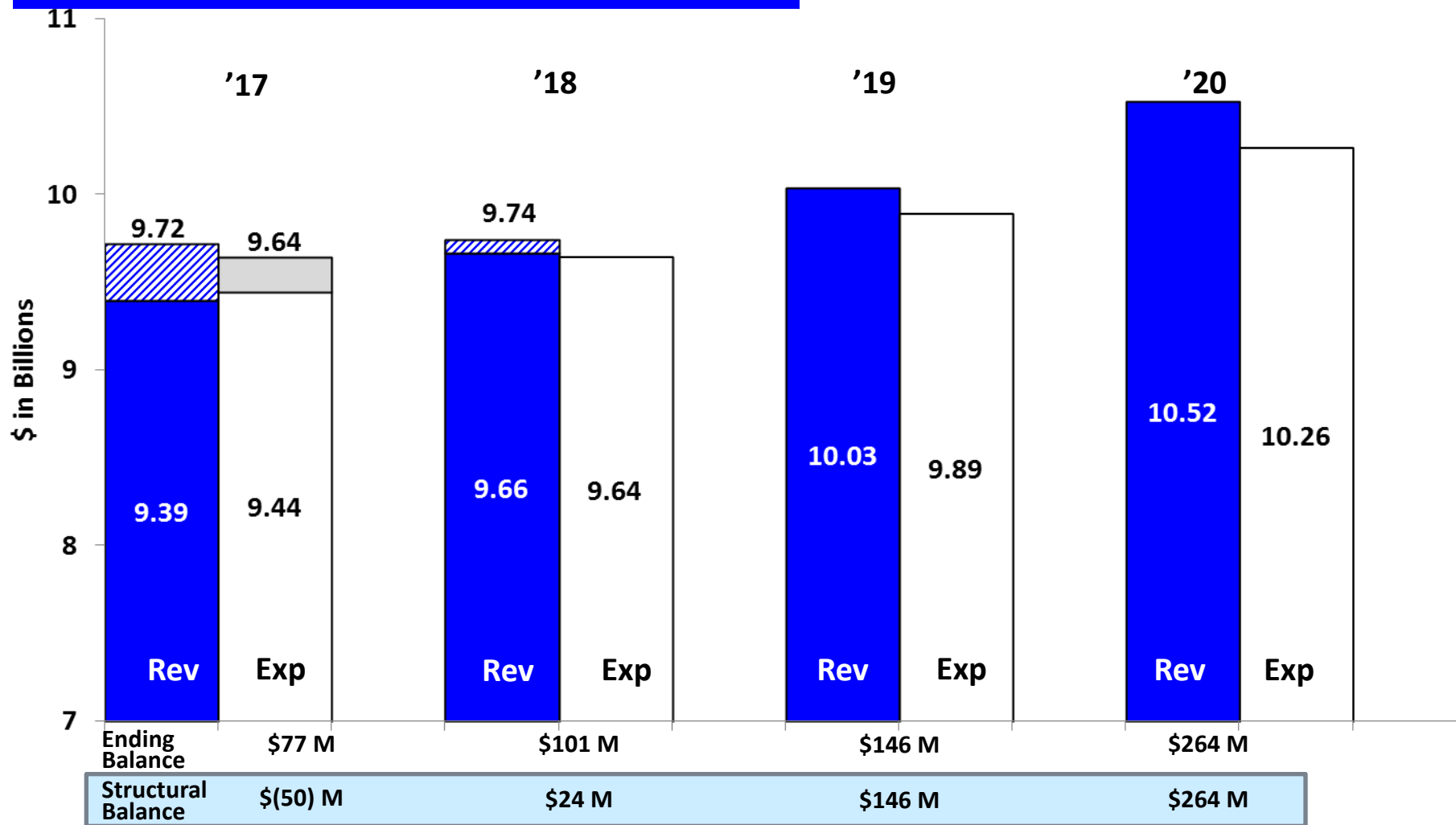
'18 Cash Balance Exceeds Structural Balance

- ❑ '17 now forecast to have \$(50) M structural shortfall
- ❑ '18 would be first structurally balanced budget since '06
- ❑ Excludes \$460 M Rainy Day Fund Balance

FY 2018 Baseline Projection

	<u>(\$ in M)</u>	
Balance Forward	\$ 77	
Ongoing Revenues	9,663	} \$24 M Structural Balance
Ongoing Spending	(9,639)	
Cash Balance	<u>\$ 101</u>	

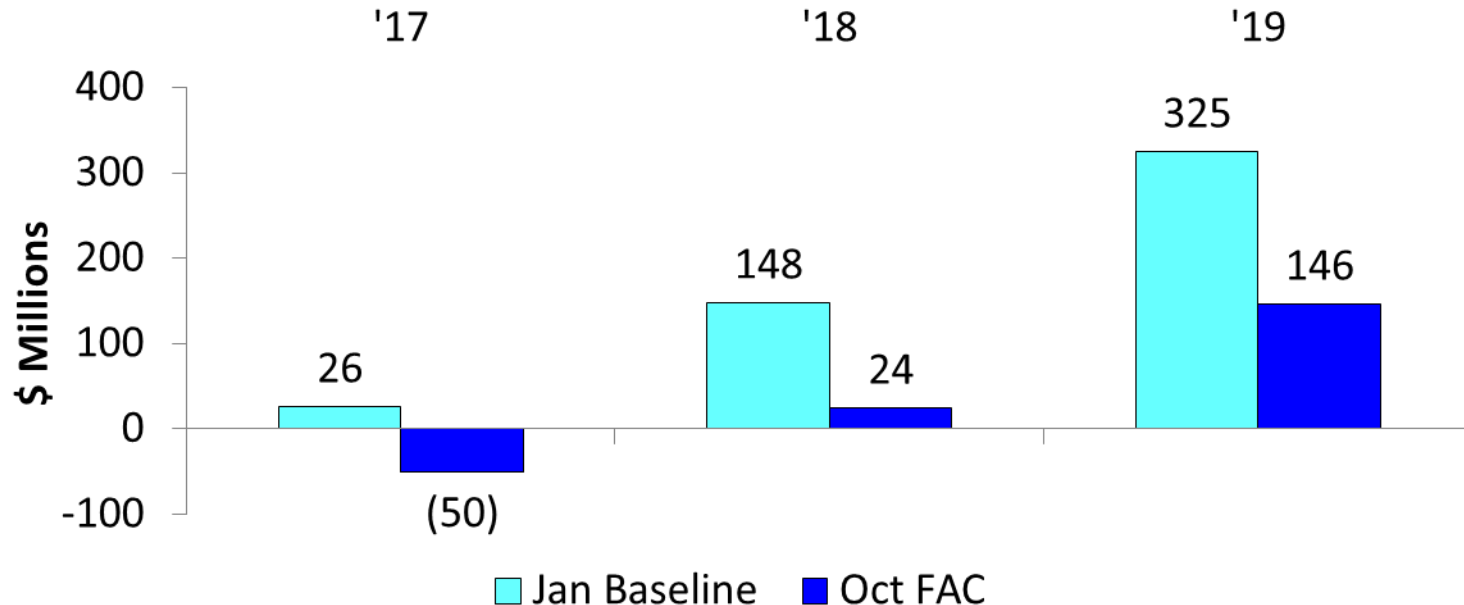
Projected General Fund Revenues & Expenditures



■ Base Revenue ■ Cash Balance / One-Time □ Ongoing Expenditures ■ One-Time Expenditures

Projected ending balances assumed to be allocated
as part of the budget process

Interpreting The Baseline Structural Balance



- ❑ Improving balances could provide more flexibility, but...
- ❑ Based on highly unlikely assumption of no discretionary changes in next 3 years and no change in the revenue forecast
- ❑ For example, lower revenues and higher spending reduced projected '18 balance from \$148 M to \$24 M in 9 months.

Appendix A: October 2016 4-Sector Forecast

	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>
Sales Tax				
JLBC Forecast	4.2%	4.1%	4.0%	4.0%
UA – Low	3.3%	2.7%	4.6%	5.8%
UA – Base	4.2%	6.0%	5.7%	5.2%
FAC	4.3%	4.2%	3.8%	4.5%
Average:	4.0%	4.2%	4.5%	4.9%
Individual Income Tax				
JLBC Forecast	4.6%	5.1%	5.4%	5.3%
UA – Low	3.7%	3.3%	4.1%	5.9%
UA – Base	4.8%	5.9%	5.1%	5.2%
FAC	4.6%	4.3%	4.5%	5.1%
Average:	4.4%	4.7%	4.8%	5.4%
Corporate Income Tax				
JLBC Forecast	1.7%	4.6%	3.5%	1.3%
UA – Low	-7.4%	-14.1%	-6.8%	13.1%
UA – Base	-3.4%	-6.3%	-2.9%	1.6%
FAC	-4.9%	1.5%	1.5%	9.2%
Average:	-3.5%	-3.3%	-0.6%	5.5%
Insurance Premium Tax				
JLBC Forecast	5.4%	4.0%	3.8%	3.3%
UA – Low	5.6%	2.9%	2.7%	2.2%
UA – Base	5.6%	2.8%	2.6%	2.6%
FAC	7.9%	7.1%	6.0%	6.1%
Average:	6.1%	4.2%	3.8%	3.6%

JLBC Weighted Average	4.3%	4.6%	4.6%	4.5%
UA Low Weighted Average	3.0%	2.2%	4.0%	5.8%
UA Base Weighted Average	4.1%	5.2%	5.0%	5.0%
FAC Consensus Weighted Average	4.1%	4.3%	4.1%	5.0%
“Big-4” Weighted Average	3.9%	4.0%	4.3%	4.9%
Consensus Weighted Average*	3.8%	4.0%	4.4%	5.0%
Adjusted Consensus Weighted Average**	2.4%	2.8%	3.6%	4.7%

* Represents ongoing revenue adjusted for small revenue categories.

** Represents ongoing revenue adjusted for tax law changes; excludes urban revenue sharing.