JLBC Staff - October 2013 Revenue and Budget Update

Summary of the General Fund Budget Outlook

- The state ended FY 2013 with $201 million more in the ending balance than budgeted.
- Year-to-date FY 2014 revenue growth has been slightly below forecast.
- Using the 4-sector forecast, Baseline revenues are projected to grow by 5.3% to 5.5% annually between FY 2015 and FY 2017.
- Under these assumptions, the state would gradually spend down the significant accumulated General Fund balance, as on-going spending is expected to exceed on-going revenue through FY 2017.
- The projected FY 2015 ending balance is $163 million. General Fund shortfalls would begin in FY 2016, with a projected ending balance of $(202) million. Excluding the FY 2016 shortfall, the FY 2017 ending balance is estimated to be $(303) million. The ending balance estimates exclude the $454 million Rainy Day Fund.

Besides this update, the JLBC Staff 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 forecast results several years in advance of FY 2017, especially given the potential for unpredictable national and international events.

2) Long term budget forecasts are subject to considerable change -- a 1% change in annual growth over 3 years has a $500 million impact in FY 2017.

3) The availability of short term balances may result in the enactment of new discretionary initiatives, which would further increase shortfalls in the outyears.

4) The updated estimates assume the continuation of approximately $300 million of annual temporary statutory suspensions.

5) The state will need to continue to monitor the potential one-time nature of FY 2013 Income Tax capital gains collections and how this will affect the FY 2014 revenue projections.

Reporting Requirements

The General Appropriation Act requires JLBC Staff to report by October 15, 2013 as to whether FY 2014's General Fund revenues and ending balance are projected to change by more than $50 million from the budgeted projections. In addition, A.R.S. § 35-125 require the Legislature to add 3-year estimates to each year's budget bill. In fulfilling these requirements, JLBC Staff has reviewed the preliminary FY 2013 ending balance estimates and updated its 4-sector revenue projections in conjunction with the October 4th Finance Advisory Committee (FAC) meeting. In addition, JLBC Staff has revised its spending projections through FY 2017 based on current statutory funding formulas.

Updated FY 2013 Estimates

The enacted budget originally assumed a FY 2013 ending balance of $694 million. Due largely to greater than expected revenues, the Arizona Department of Administration (ADOA) projects the FY 2013 ending balance to be $895 million, or $201 million higher than forecast. ADOA will publish a final FY 2013 ending balance figure by December 1.

In terms of revenue, the budget projected that FY 2013 base revenues (excluding one-time adjustments) would increase by 4.0% compared to the prior year. Instead, base revenues grew by 6.4%, a result of strong Individual Income Tax payments which were partly due to the one-time acceleration of capital gains caused by federal policy changes at the end of calendar year 2012.

FY 2014 - 2017 Revenue Projections

The enacted FY 2014 budget assumed base revenue growth of 4.9%, which excludes one-time adjustments, enacted tax law changes and urban revenue sharing. Based on preliminary September projections, first quarter FY 2014 General Fund revenues are 4.4% above last year. This year-to-date figure reflects the change in total revenues, however, it is estimated that the impact of tax law changes up to this point during FY 2014 is minimal.

In the first quarter of FY 2014, preliminary collections were as follows:

- Sales tax collections were up by 6.6%,
- Individual Income tax collections grew by 6.6%
- Corporate Income tax collections decreased by (24.2)%, mostly due to significant refunds issued in September

In total, General Fund revenues are $(12.6) million below the enacted budget forecast.

The FY 2014 to FY 2017 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 3.5% in FY 2014, which may be viewed as being pessimistic when compared to forecasted growth rates of greater than 5% in other years. However, the overall FY 2014 growth rate is lowered by 2 significant factors:

- *Adjusting for one-time capital gains incurred in FY 2013* – At the end of calendar year 2012, taxpayers faced certain potential federal policy changes (such as an increase in the tax rates for long-term capital gains and dividend income) along with certain actual changes (such as a 3.8% tax on higher income households as part of funding federal health care changes). These policies (which would occur on January 1, 2013) incentivized companies to issue dividends and stockholders to take capital gains in calendar year 2012, which accelerated collections into FY 2013 and likely reduced collections in future years. JLBC Staff has estimated the magnitude of this impact to be $103 million, which lead to the FY 2014 4-sector consensus forecast being reduced by a corresponding $(103) million. However, the FY 2014 forecast amount does still account for underlying growth in stock market valuations.
- *UA Low Forecast Fell Below Other Sectors* – The UA Low Revenue models (which comprises 25% of the 4-sector projection) had a growth rate of 2.7% in FY 2014, as compared to rates of 4.5 - 4.8% for other components. Without this UA "low" input, the 4-sector forecast would have resulted in a forecasted revenue gain of 5.2%. The reasonableness of including the UA "low" input at a 25% weight does coincide with national economic forecasts, which place the odds of a "stalled recovery", or low growth, at 20%.

In future years, the 4-sector consensus forecast estimates growth rates of: 5.3% in FY 2015, 5.4% in FY 2016, and 5.5% in FY 2017. Details of the October 2013 FAC consensus forecast are summarized in *Attachment A*.

In addition to the consensus forecast for base revenues (which reflect underlying economic conditions), the long-term budget estimates also make adjustments for other factors:

<u>Elimination of Fund Transfers</u> – The long-term budget projections assume the elimination of one-time fund transfers, leading to a General Fund revenue loss of $(134) million in FY 2015.

<u>Previously Enacted Tax Legislation</u> – Relative to the prior fiscal year, previously enacted tax law changes will have a General Fund impact of $(139) million in FY 2015, $(114) million in FY 2016 and $(95) million in FY 2017. These estimates reflect the nominal values of the tax reductions and are not adjusted for any offsetting economic activity which may be generated by the tax reductions.

<u>Urban Revenue Sharing</u> – 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 $561 million in FY 2014 to $609 million in FY 2015. This $48 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 $620 million in FY 2016 and increase to $631 million in FY 2017.

After factoring in these adjustments, along with changes in the state's beginning cash balance, total available General Fund revenue is forecast to decline gradually from $9.4 billion in FY 2014 to $9.2 billion in FY 2016. At that point, revenues are then expected to increase to $9.5 billion in FY 2017. The bottom line revenue decline in FY 2015 and FY 2016 reflects the draw down of the significant accumulated General Fund balance, as on-going spending exceeds on-going revenue over the next several years.

Risks to the Revenue Forecast

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

- As is typical in multi-year forecasting, unexpected events often have economic consequences.

- The Federal Reserve Board continues to keep its 0% interest rate policy in place, and there are questions about the eventual impact when the policy is modified.

- The on-going government shutdown and upcoming debt ceiling deadline have the potential to adversely affect financial markets, along with consumer and business confidence.

Future Year Spending Estimates

The JLBC Staff has also updated its FY 2015 to 2017 Baseline spending estimates. The estimates reflect the standard methodology of estimating the annual growth in statutory and other active funding formulas. The updated estimates incorporate the following adjustments:

- K-12 state aid formula growth. This item has the following components: 1) Student growth which increases annually by 1.1% - 1.3% through FY 2017; 2) The result of the recent Arizona Supreme Court decision requiring an annual inflation adjustment for the entire K-12 formula, with an average annual cost of $100 million; 3) Enacted policy changes which increase K-12 expenses, such as the business property tax assessment ratio declining from 20% to 18% over several years and the corresponding increase in the Homeowner's Rebate; and 4) The impact of traditional district schools converting to district sponsored charter schools, which is expected to increase costs by $140 million annually by FY 2017. In total, K-12 spending is projected to increase by $181 million in FY 2015, $204 million in FY 2016 and $251 million in FY 2017.

- Medicaid caseload growth in AHCCCS and the Department of Health Services. These adjustments incorporate the effect of the recently enacted Medicaid expansion and hospital assessment. The figures are similar to those assumed in the enacted budget, due to the relative lack of new enrollment information before eligibility changes occur on January 1, 2014.

- Department of Economic Security Medicaid and other caseload growth. This item reflects Developmental Disabilities caseload growth of 4.5% per year which corresponds to average annual increases ranging from $21 million - $29 million through FY 2017. The estimates also assumes that the state backfills the partial loss of federal Long Term Care funding (which is currently used to support other DES programs) for a permanent annual cost of $25 million.

- Universities parity funding, which reflects the state's commitment to reach parity in per-student state funding at each of the state's 3 universities by FY 2017.

- 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 security public beds in FY 2015. The operating costs of these new prison beds, along with marginal population costs and the state's existing inmate health care contract, are expected to add $28 million in FY 2015, $10 million in FY 2016 and $3 million in FY 2017.

- The elimination of $(50) million of capital funding, which is related to the construction of the state's 500 new maximum security public prison beds.

In terms of standard funding formula requirements, overall spending is projected to grow by $229 million in FY 2015 (2.6%), $335 million in FY 2016 (3.7%) and $364 million in FY 2017 (3.9%). The individual components of these adjustments can be found in the JLBC Staff presentation.

The updated projections also assume 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 estimates, spending would increase by approximately $300 million.

Future Year Balance Projections

Using the latest 4-sector consensus revenue forecast, along with the updated spending projections, the state would have an ending balance of $570 million in FY 2014 that would decline to $163 million in FY 2015 as on-going spending continued to exceed on-going revenues.

In FY 2016, the ending balance has a projected shortfall of $(202) million. The magnitude of the FY 2017 shortfall depends on whether the FY 2016 shortfall is resolved before the end of the year. If the FY 2016 shortfall is resolved through one-time measures, the projected FY 2017 shortfall is $(303) million. If the FY 2016 shortfall is rolled into FY 2017, the latter-year shortfall would be $(505) million. Conversely, if the FY 2016 shortfall is eliminated with permanent initiatives, the FY 2017 shortfall would fall to $(101) million.

These balance estimates do not include the $454 million in the state's Budget Stabilization Fund (otherwise known as the Rainy Day Fund).

Table 1 summarizes the FY 2014 – FY 2017 ending balance projections:

Table 1

Ending Balance Projections

	Fiscal Year				
	14	**15**	**16**	**17 A**	**17 B**
Beginning Balance	$ 0.9 B	$ 0.6 B	$0.2 B	$ -	$(0.2) B
Revenues	8.5 B	8.6 B	9.0 B	9.5 B	9.5 B
Spending	8.8 B	9.1 B	9.4 B	9.8 B	9.8 B
Ending Balance	$570 M	$163 M	$(202) M	$(303) M	$(505) M

Attachment A

October 2013 FAC Forecast
FY 2014 - FY 2017

	FY 2014	FY 2015	FY 2016	FY 2017
Sales Tax				
JLBC Forecast	5.9%	5.6%	6.1%	6.2%
UA - Low	3.5%	3.0%	4.9%	6.3%
UA - Base	5.7%	6.6%	6.7%	6.9%
FAC	5.5%	5.0%	5.5%	5.3%
Average:	**5.2%**	**5.1%**	**5.8%**	**6.3%**
Individual Income Tax				
JLBC Forecast	3.2%	5.7%	5.6%	5.6%
UA - Low	0.7%	2.6%	3.9%	5.1%
UA - Base	2.8%	4.6%	6.2%	5.9%
FAC	4.0%	5.7%	5.1%	5.4%
Average:	**2.7%**	**4.7%**	**5.2%**	**5.5%**
Corporate Income Tax				
JLBC Forecast	2.5%	3.7%	4.2%	5.6%
UA - Low	8.1%	6.7%	6.2%	-2.5%
UA - Base	9.7%	14.3%	10.7%	2.0%
FAC	1.8%	5.0%	4.0%	6.4%
Average:	**5.5%**	**7.5%**	**6.5%**	**2.6%**
JLBC Weighted Average:	**4.5%**	**5.5%**	**5.8%**	**5.9%**
UA Low Weighted Average:	**2.7%**	**3.2%**	**4.6%**	**5.3%**
UA Base Weighted Average:	**4.8%**	**6.4%**	**6.8%**	**6.2%**
FAC Consensus Weighted Average:	**4.6%**	**5.3%**	**5.2%**	**5.5%**
"Big-3" Weighted Average:	**4.1%**	**5.1%**	**5.6%**	**5.7%**
Consensus Weighted Average: *	**3.5%**	**5.3%**	**5.4%**	**5.5%**
Adj. Consensus Weighted Average: **	**2.8%**	**3.6%**	**4.1%**	**5.4%**

* Consensus Big-3 Categories adjusted for Small Categories

** Consensus Weighted Average adjusted for Tax Law Changes