JLBC Staff - October 2011 Revenue and Budget Update

Summary of the Budget Outlook

- Since the FY 2011 shortfall no longer has to be paid off with FY 2012 revenues, the state will likely generate a carry-forward balance at the end of FY 2012.

- Due to economic uncertainty and pending "budget" litigation, it is difficult to predict the magnitude of the FY 2012 balance. As a result, the JLBC Staff has developed 2 different scenarios.

- The projected carry-forward balance at the end of FY 2012 is $130 million in one scenario and $415 million in a second scenario. Since the balance is one-time in nature, using these monies for permanent revenue or spending initiatives would increase future year shortfalls.

- After estimating revenue and funding formula changes for next year, it is not yet clear whether the FY 2013 budget will be in balance or in a shortfall. One model predicts a $140 million surplus while the second "slow economy" model would result in a $(375) million shortfall.

- With the expiration of the 1-cent sales tax, however, we are more likely to incur a shortfall in FY 2014 under either scenario. The shortfall is $(600) million in the first scenario and $(1.2) billion in the second.

- 3-year budget estimates are highly speculative and subject to considerable change. For example, a small revenue forecast error of 1% across 3 years could result in a $500 million revision to the projections in either direction. As a result, the current FY 2014 estimates will probably change considerably over the next 3 years.

Besides this document, the JLBC Staff has also developed a slideshow presentation of this issue that can be found on our website at: October 18 FAC Meeting.

Updated FY 2012 Estimates

The General Appropriation Act requires JLBC Staff to report by October 15, 2011 as to whether FY 2012's General Fund revenues and ending balance are expected to change by more than $50 million from the budgeted projections. To assist in this task, the JLBC has updated its 4-sector revenue estimates in conjunction with the Finance Advisory Committee (FAC) meeting of October 18, 2011. Besides the FAC panelists, the 4-sector Consensus includes input from 2 econometric models at the University of Arizona and the JLBC Staff.

Budget Uncertainties in FY 2012 - The current revenue and budget environment makes ending balance projections especially challenging. While state revenues have been growing for the last year, there is considerable economic uncertainty at the international and national level. Several leading forecasters suggest that the chance of a recession in the near term is 40% to 50%. As a result, it is difficult to develop a forecast that addresses the possibility of a recession in the midst of growing state revenues.

In addition, state spending could be greatly affected by litigation that seeks to overturn prior legislative decisions. For example, the state is being sued with regard to its decision to impose an enrollment freeze on the childless adults in the Medicaid program. The state is also being challenged for its interpretation of how to calculate an inflation adjustment in K-12 state aid, as required by Proposition 301. If plaintiffs are successful in both these lawsuits, state costs could rise by over $200 million.

The state could also be required to set aside part of any year-end balance to meet federal Internal Revenue Service (IRS) requirements related to the state's issuance of $1.5 billion in tax exempt financing in FY 2010. Those state building sale/leaseback and lottery bond proceeds were used to fund state operating costs. The IRS does not normally permit tax exempt issuances to be used for operating purposes. The state agreed, however, to dedicate any balance above 5% of its budget (or approximately $415 million) to debt repayment or other purchases of federal government securities.

The state balance may exceed $415 million in FY 2012, thereby triggering the IRS payment requirement. The calculation, however, is complex and will require further analysis in the coming months.

Potential Gains in FY 2012 - Despite these uncertainties, the state will benefit from stronger than expected revenue growth at the end of FY 2011. As enacted in April, the revised FY 2011 budget had an anticipated shortfall of $(332) million based on a projected base revenue growth rate of 5.6%. The base growth rate reflects the change in ongoing revenues without one-time adjustments or tax law changes. The April budget anticipated that this FY 2011 shortfall would be repaid from FY 2012 revenues.

Due to especially high growth in individual income tax collections as part of tax filing season, base revenues grew by 11.1% in FY 2011. This higher than expected growth appears to have eliminated the projected FY 2011 shortfall. Based on preliminary estimates, the Department of Administration has estimated that FY 2011 will have an ending balance of $3 million. Since none of the FY 2012 revenues will have to be dedicated to paying off the FY 2011 shortfall, those monies will be freed up in the FY 2012 budget.

Given the higher than expected FY 2011 base, FY 2012 revenues may be higher than budgeted. The enacted April budget assumed FY 2012 base revenues would grow by 5.7% to $7.83 billion. With the higher than expected FY 2011 base, this level could be achieved with a 1.0% growth rate in FY 2012. Based on the updated 4-sector Consensus, revenues are now projected to grow by 2.9% in FY 2012. At this rate, we would generate an additional $150 million in revenue above forecast.

Only 1 of the 4 sectors of the Consensus forecast, however, builds in the possibility of a recession in FY 2012. If a recession were to occur, the 4-sector estimates would be too high and the state would be unlikely to generate any excess revenue above the FY 2012 budget.

FY 2012 Carry-Forward Balance Estimate - In summary, the FY 2012 balance will benefit from no longer having to pay off the FY 2011 shortfall. The ultimate magnitude of the balance, however, will depend on whether a) the state generates excess revenues on the FY 2012 base; b) the plaintiffs prevail in their "budget" litigation; and c) the IRS payment requirements are triggered. Depending on those outcomes, the FY 2012 ending balance could be $130 million or $415 million.

In lieu of any other action, this amount will represent the FY 2012 carry forward into FY 2013. The state may also consider other uses of these funds. This decision, however, should be evaluated relative to the long run status of the budget. As described below, a shortfall is being projected in FY 2014 with the expiration of the 1-cent sales tax. Therefore, the use of the FY 2012 balance for a permanent revenue or spending initiative would serve to increase that shortfall. Among numerous options, possible one-time use of the funds include: 1) leaving the funds in the state's carry-forward balance to resolve future shortfalls, 2) depositing funds into the state's rainy day fund (the Budget Stabilization Fund), 3) paying off prior year debt obligations, and 4) paying off prior year "rollovers."

Future Year Revenue Estimates

The updated 4-sector Consensus projects that base General Fund revenues would grow by 4.9% in FY 2013 and further grow by 7.6% and 8.5% in FY 2014 and FY 2015 respectively. The FY 2014 and FY 2015 rates would exceed Arizona's pre-recession historical revenue growth rate of 7%.

Revenue growth of that historical magnitude is usually fueled by population growth of 3%. In the past several years, the net population change has been essentially flat. Returning to the historical growth rates would require an improvement in the national economy which would spark renewed interstate migration.

Consistent 7% revenue growth would also require a recovery in Arizona's housing industry. The annual level of housing permits is still near 10,000, compared to 50,000 in a healthy economy. Several state forecasters believe that the current oversupply of housing will substantially diminish over the next 3 years, which would then set the stage for more new permits and construction growth.

The Consensus forecast, however, poses major risks from a budget standpoint. In the short term, the Consensus may not give adequate weight to the possibility of a national recession. As noted earlier, only 1 of the 4 sectors clearly includes the possibility of a recession. Several leading national forecasters such as Global Insights and Moody's Analytics places the odds of a recession at 40% to 50%.

In the long term, revenue forecasts are usually more cautious in the out years due to the inherent uncertainty of future events. The last decade demonstrates this uncertainty. In FY 2004, forecasters did not envision the 40% base revenue growth in the following 2 years. In FY 2008 likewise, forecasters did not foresee that revenues would fall by a third over the next several years. In addition, small forecast errors over 3 years can result in large shifts in revenues. For example, a 1% error in the growth rate during a 3-year period of time could change total revenue collections by $500 million.

While forecasts usually grow more cautious over time, the Consensus forecast is increasingly optimistic through FY 2015. Given the difficulty of 3-year projections, the Consensus results may result in a false sense of optimism.

To address these concerns, the JLBC Staff has made 2 modifications to the Consensus Baseline estimates:

- Added a second "slow economy" scenario to the Baseline at rates 2% below the Consensus, and

- Capped the Consensus revenue growth rates for budgeting at 7% in any one year to reflect the state's long-term average annual revenue growth rate prior to the 2008-2010 recession.

Future Year Spending Estimates

The JLBC Staff has also updated its FY 2012 to 2015 Baseline spending estimates. The Baseline reflects the standard methodology of estimating the annual growth in statutory and other active funding formulas. The Baseline also assumes the continued annual suspension of any inactive formulas. Each year, the Legislature enacts an annual session law provision which serves to only suspend, not repeal, certain statutory formulas. If those inactive formulas were counted in the Baseline, spending would increase by $730 million. Most of the ongoing annual suspensions are for the K-12 operating budget ($300 million) and the School Facilities Board capital budget ($400 million).

The Baseline also includes the current law requirements relative to the federal health care legislation enacted in 2010. While AHCCCS has received a waiver from the federal government to freeze participation in the Proposition 204 childless adult and some other programs, that exemption would end in January 2014. Several other requirements also become effective at that time, including expanding the AHCCCS population coverage for adults from 100% to 133% of the federal poverty line. The federal government, however, will pay 100% of that expansion cost in the short term.

Based on the state's active funding formula requirements, spending is projected to grow by $132 million in FY 2013 to a level of $8.5 billion. Spending growth is forecast to accelerate to

$432 million in FY 2014 as the state reinstates the full Proposition 204 population and begins to bring on line 5,000 new private prison beds already authorized in law.

As with revenues, long-term spending projections are inherently uncertain. As described above, "budget" litigation and the IRS payment provisions could cause an increase in the long-term estimates. In addition, federal budget negotiations may lead to a reduction in state aid. As the federal government explores means of reducing its own shortfalls, the most direct impact on state government would result from any changes in the federal matching rate for Medicaid expenses. While federal assistance may be reduced in FY 2012, it would most likely affect discretionary programs. Reductions in federal discretionary spending would not result in automatic state funding backfills. Federal Medicaid reductions are unlikely until at least FY 2013 *(See JLBC's August Monthly Fiscal Highlights for more discussion of this issue.)*

Future Year Balance Projections

Given the revenue and spending risks in the budget through FY 2015, JLBC Staff has developed 2 Baseline scenarios. Scenario 1 includes the Consensus revenue projections and active funding formula spending estimates. In contrast, Scenario 2 takes a more cautious perspective by reducing the Consensus revenue estimates by 2%. Scenario 2 also adds $200 million in spending if the plaintiffs are successful in their budget lawsuits against the state.

Under Scenario 1, the FY 2013 budget could range from a $143 million balance while Scenario 2 leads to a ($375) million shortfall. In FY 2014, both scenarios produce a shortfall due to the expiration of the 1-cent sales tax. The shortfall is $(600) million in Scenario 1 and $(1.2) billion in Scenario 2. *(See Table 1)*

Table 1

	Fiscal Year		
Scenario 1	**12**	**13**	**14**
Revenues	$8.8 B	$8.7 B	$8.3 B
Spending	$8.4 B	$8.5 B	$8.9 B
Balance	$416 M	$143 M	$(610) M
Scenario 2			
Revenues	$8.7 B	$8.3 B	$7.8 B
Spending	$8.5 B	$8.7 B	$9.1 B
Balance	$133 M	$(375) M	$(1.2) B

These 2 scenarios do not represent a lower and upper bound of possible outcomes. Outside factors could influence the magnitude of the state's budget balance, including federal efforts to balance their own budget. As noted earlier, small forecast revenue errors can produce large changes in the actual budget picture.