Finance Advisory Committee

Revenue and Budget Update

October 18, 2011

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Summary of the Current Budget Status

Improving, but Difficult to Predict Next 3 Years Reliably

- FY ’11 Base General Fund revenue growth of 11% eliminated the FY ’11 projected shortfall of $(332) million.
- Since FY ’12 monies will no longer be needed to pay off the FY ’11 shortfall, there will likely be a carryforward balance at the end of FY ’12
- At the current time, difficult to predict magnitude of FY ’12 balance due to economic and litigation uncertainty.
  - Some national forecasters place odds of recession at 40% to 50%
  - Prop 204 and other "budget" lawsuits could significantly increase spending.
- Given these uncertainties, JLBC Staff has projected the FY ’12- FY ’15 Baseline estimates under 2 different scenarios.

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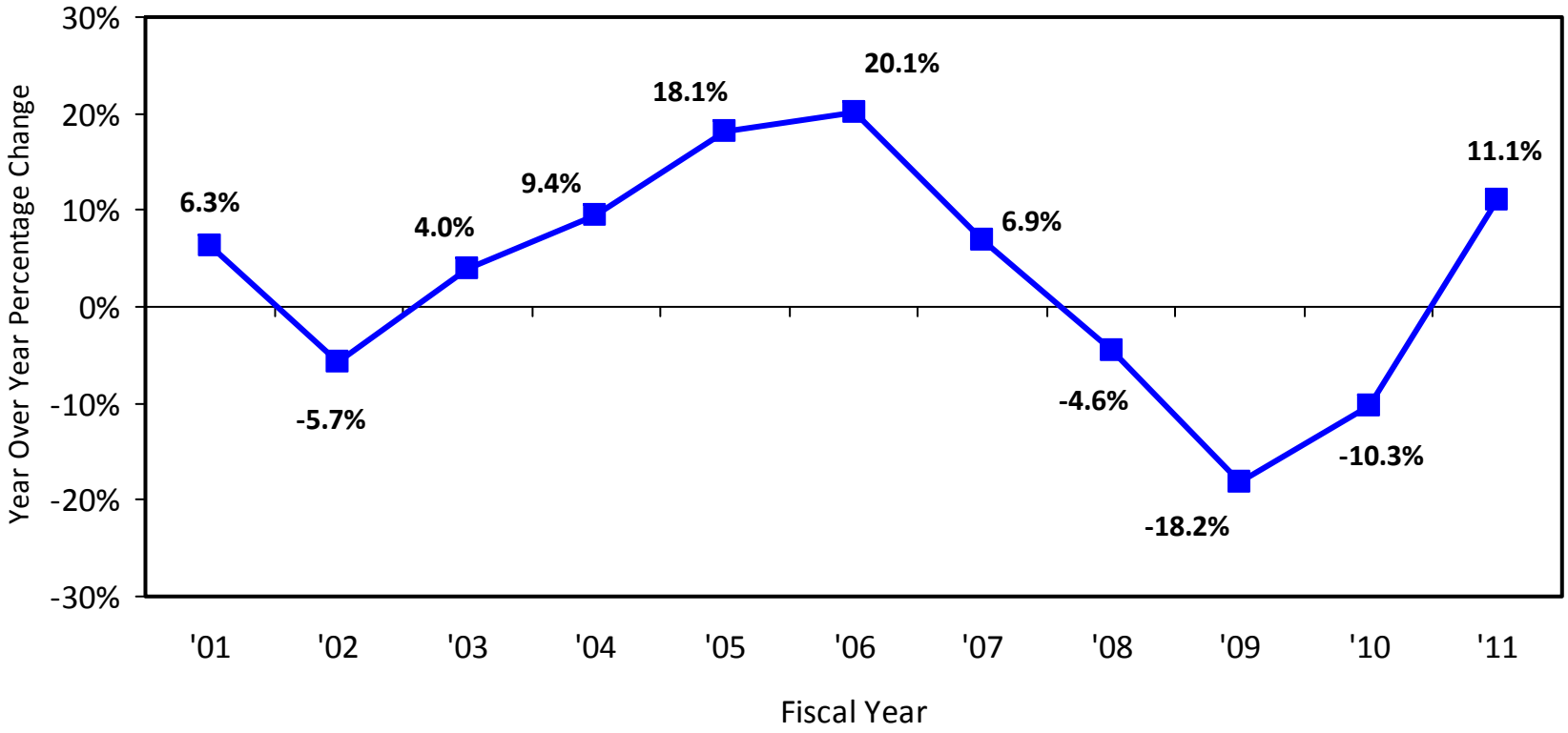
FY ’11 Base Revenues Post Gain After Unprecedented 3-Year Decline



Percent Change in Base Revenues Excluding Urban Revenue Sharing, statutory and one-time changes.

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FY ’11 Rebound Led By Income Taxes

- Eliminated FY ’11 Shortfall of $(332) Million

	FY ’11 Over ’10	
	Budgeted	Prelim. Actual
Sales*	2.9%	1.9%
Individual Income	5.9%	18.5%
Corporate Income	40.8%	35.6%

* Without 1-Cent

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The FY ’11 Recovery Is a Reflection of 1-Time Factors

- FY ’10 was the bottom of the recession when revenues fell below FY ’04 level – easier to post gains off such a low base
- Corporate profitability rose considerably – more due to higher productivity than higher revenues
- Individual income increase is more likely a function of capital gains and a loss of mortgage deductions than of significant job and wage growth

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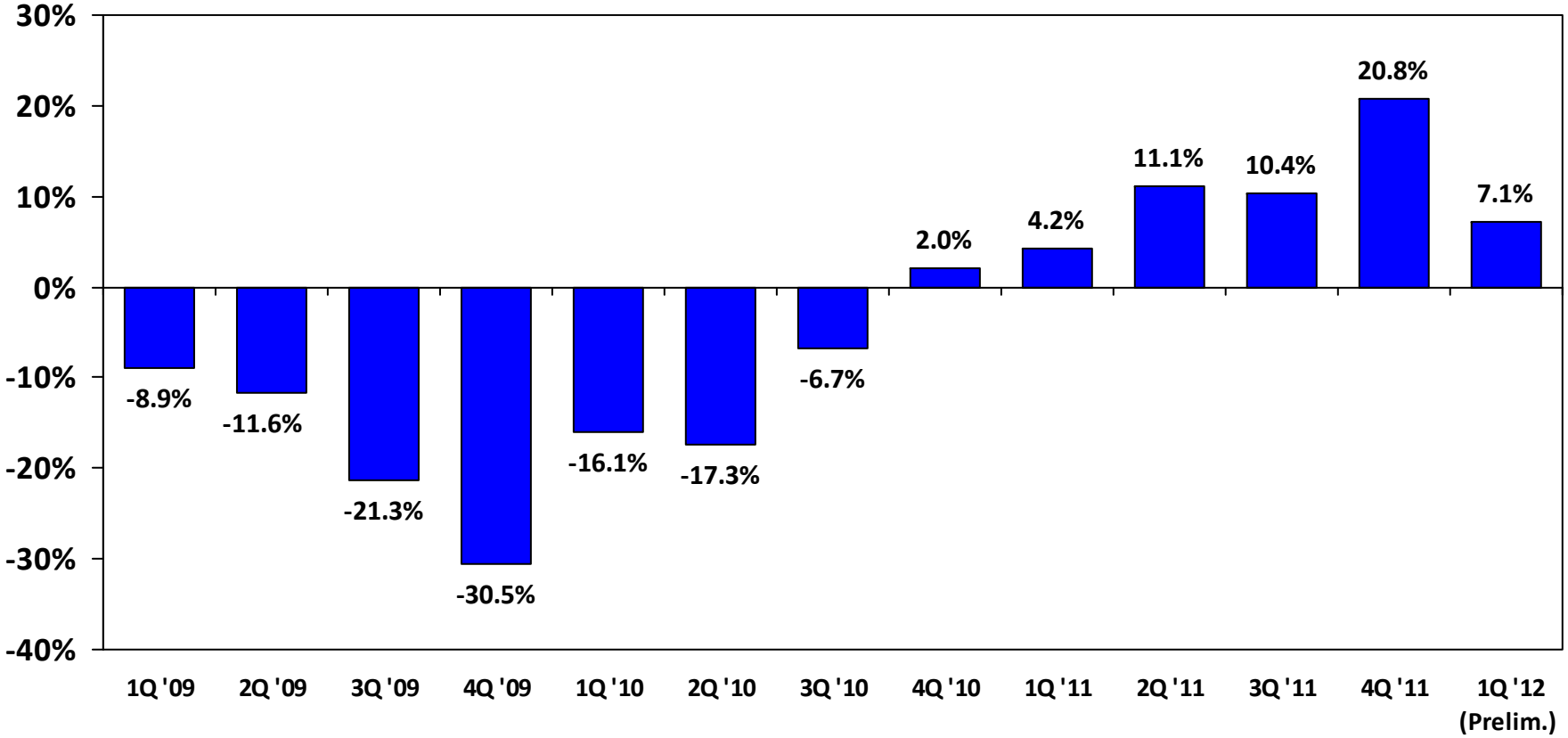
Arizona Has 6 Consecutive Quarters of General Fund Revenue Growth



Percent Change in Adjusted Revenues Excluding 1-Cent Sales Tax

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1st Quarter Growth Rate 7.1%

- July and August are Final, September is Preliminary Projection
- $126 M Above Forecast

	% Change over 1st Qtr. FY '11
Sales Tax (without 1-cent)	7.2%
Individual Income Tax	9.8%
Corporate Income Tax	10.9%

- Strong sales performance partially due to negative 1st quarter in FY '11
- Healthy growth rate in April income tax collections resulted in higher estimated payments for the rest of calendar 2011

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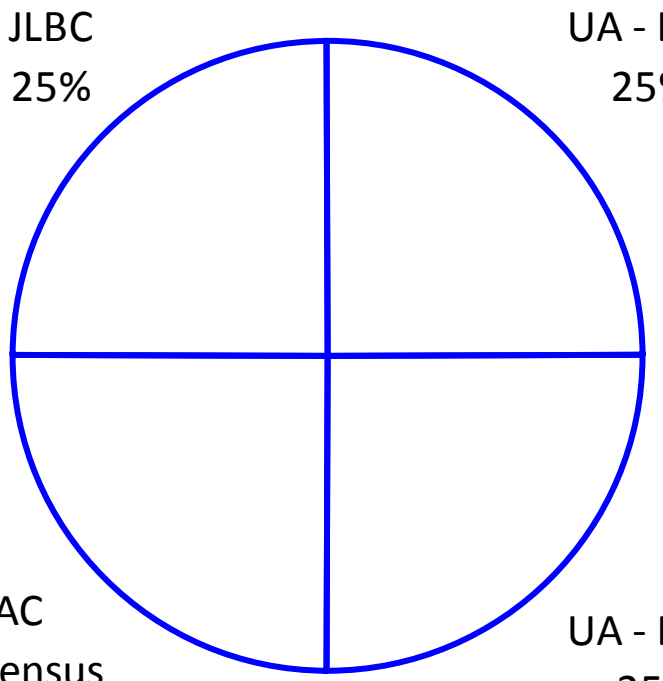
Where Are We Headed Over the Next Few Years?
- Four-Sector Consensus Forecast Incorporates Different Economic Views, Including the FAC

4-sector forecast equally weights:

- 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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Forecasting Constraints In the Next 3 Years

- While revenue recovery has begun, it is difficult to forecast its speed
- Current forecasts are most useful in determining the direction of the economy, not its precise landing point
- Certain structural factors limit potential for rapid growth
- Small forecast errors can have a large impact -- 1% error in the revenue growth rate over 3 years can change revenue collections by $500 million

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The Road to Recovery Will Still Be Long

- Decline in Pending Foreclosures Is One Positive Sign

	Highpoint	Now
Jobs Lost Since December 2007	398,800 (July 2010)	326,900*
Pending Maricopa Foreclosures	51,500 (Dec. 2010)	23,299
Mortgages Underwater	51.3% (Q4, 2009)	48.7% (Q2, 2011)

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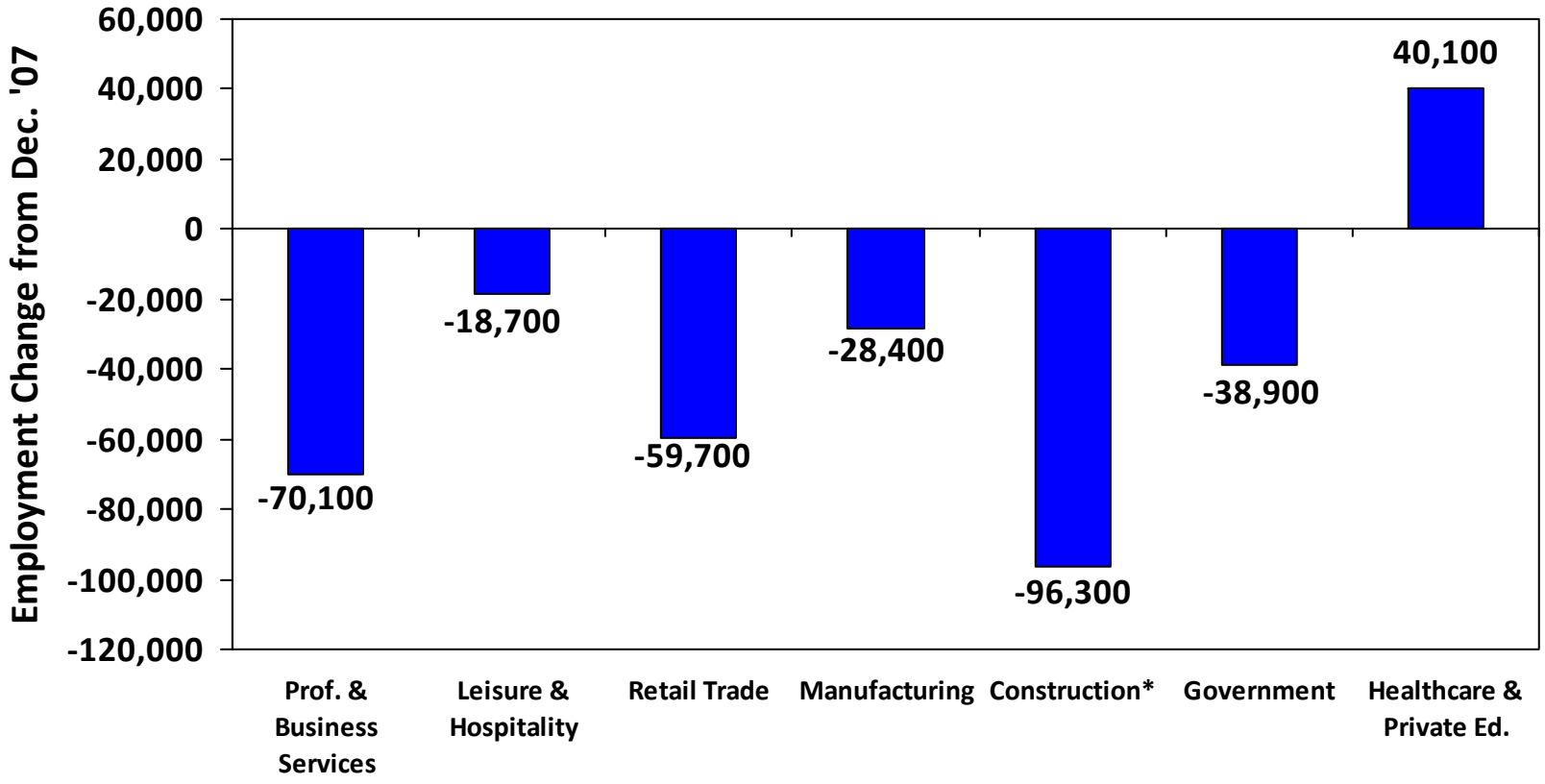
*** Due to seasonal decline of summer jobs, overstates actual loss**

Job Losses Since December 2007 by Sector

- Of 326,900 lost jobs, 96,300 were in construction



*** Construction employment peaked in June 2006. Total loss is 133,800 jobs.**

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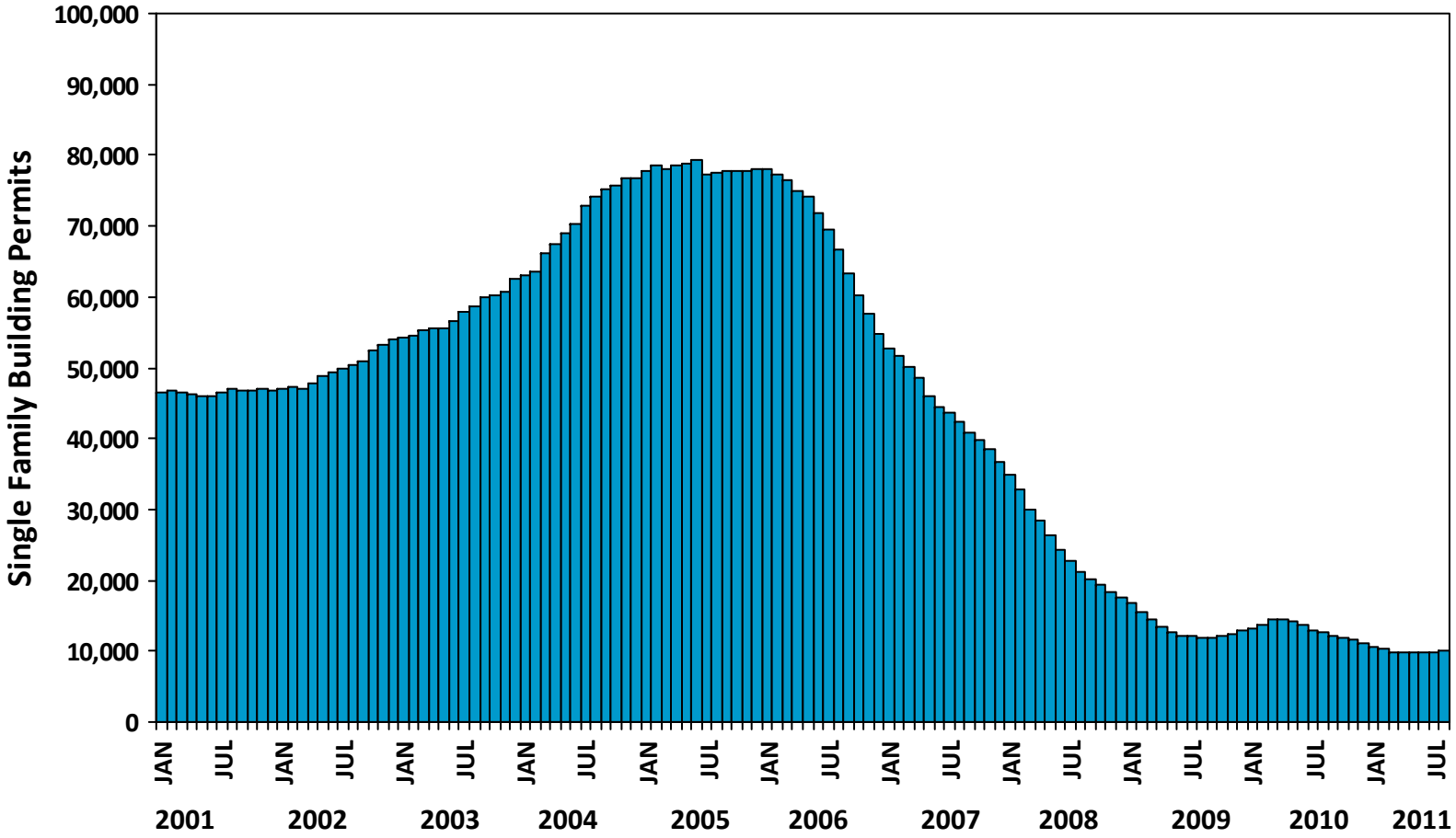
Single Family Permits Suggest Construction Recovery Not Imminent



12-Month Moving Sum

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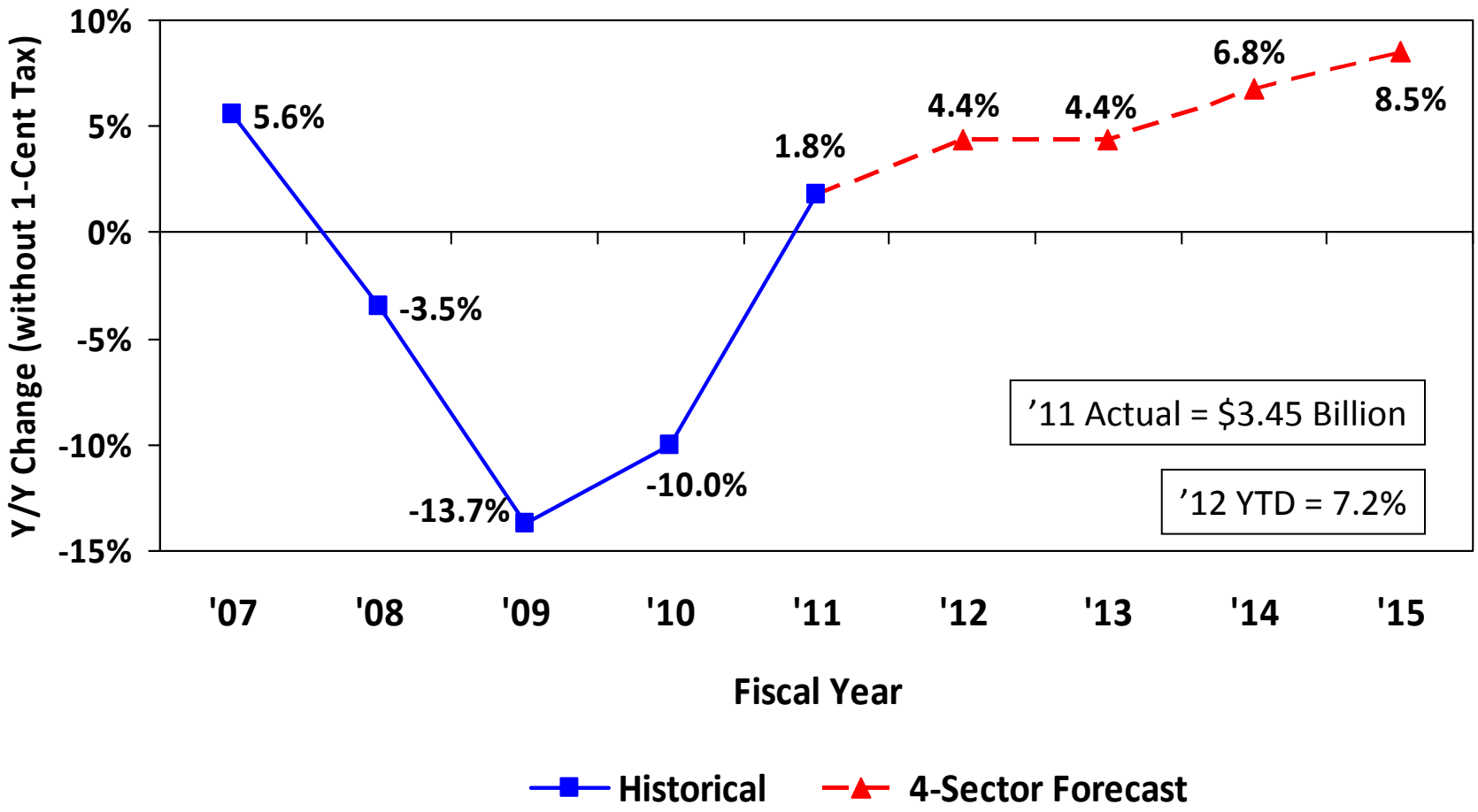
Sales Tax

- The Consensus Forecasts Growth of 4.4% in FY ’12 and 4.4% in FY ’13



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

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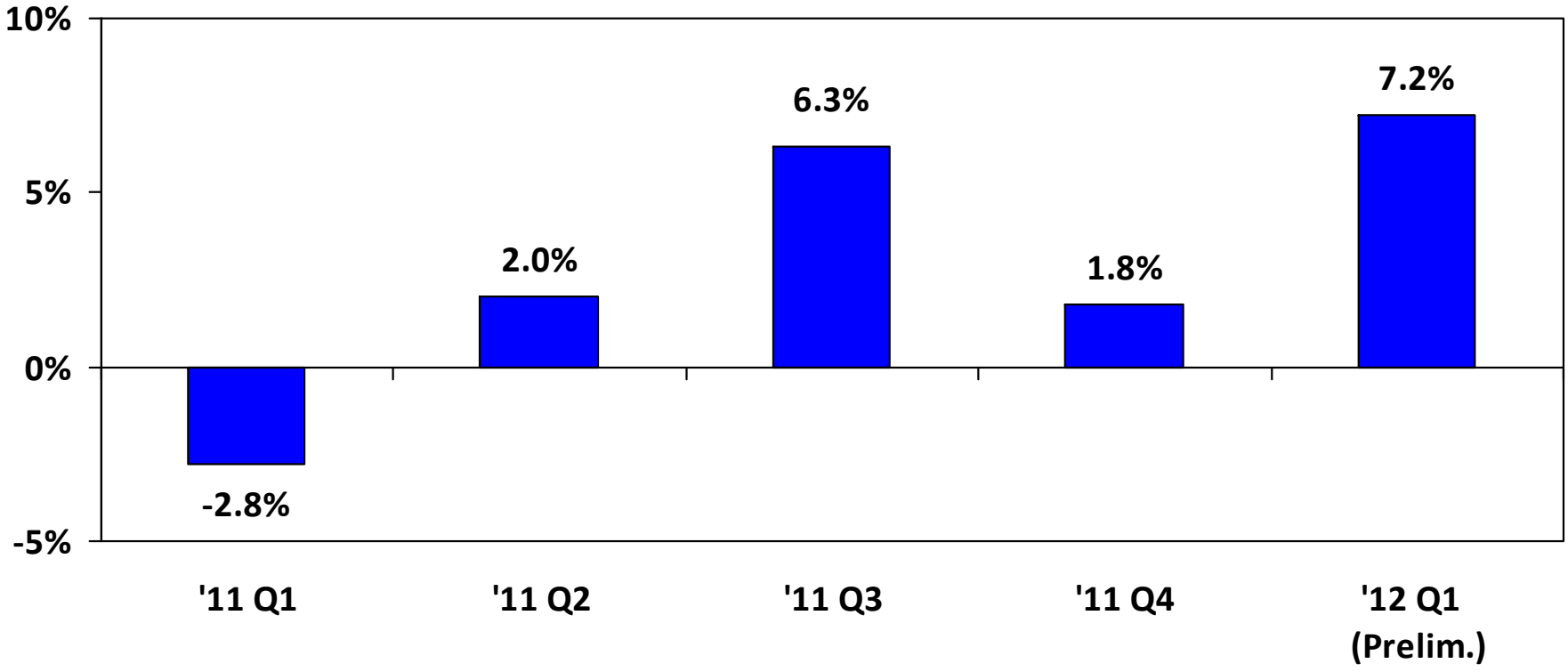
Strong 1st Quarter In FY ’12 Growth Relative to Negative FY ’11

- Recovery Started in 2nd Quarter FY ’11



Percent Change in Adjusted Sales Tax Excluding 1-Cent Tax

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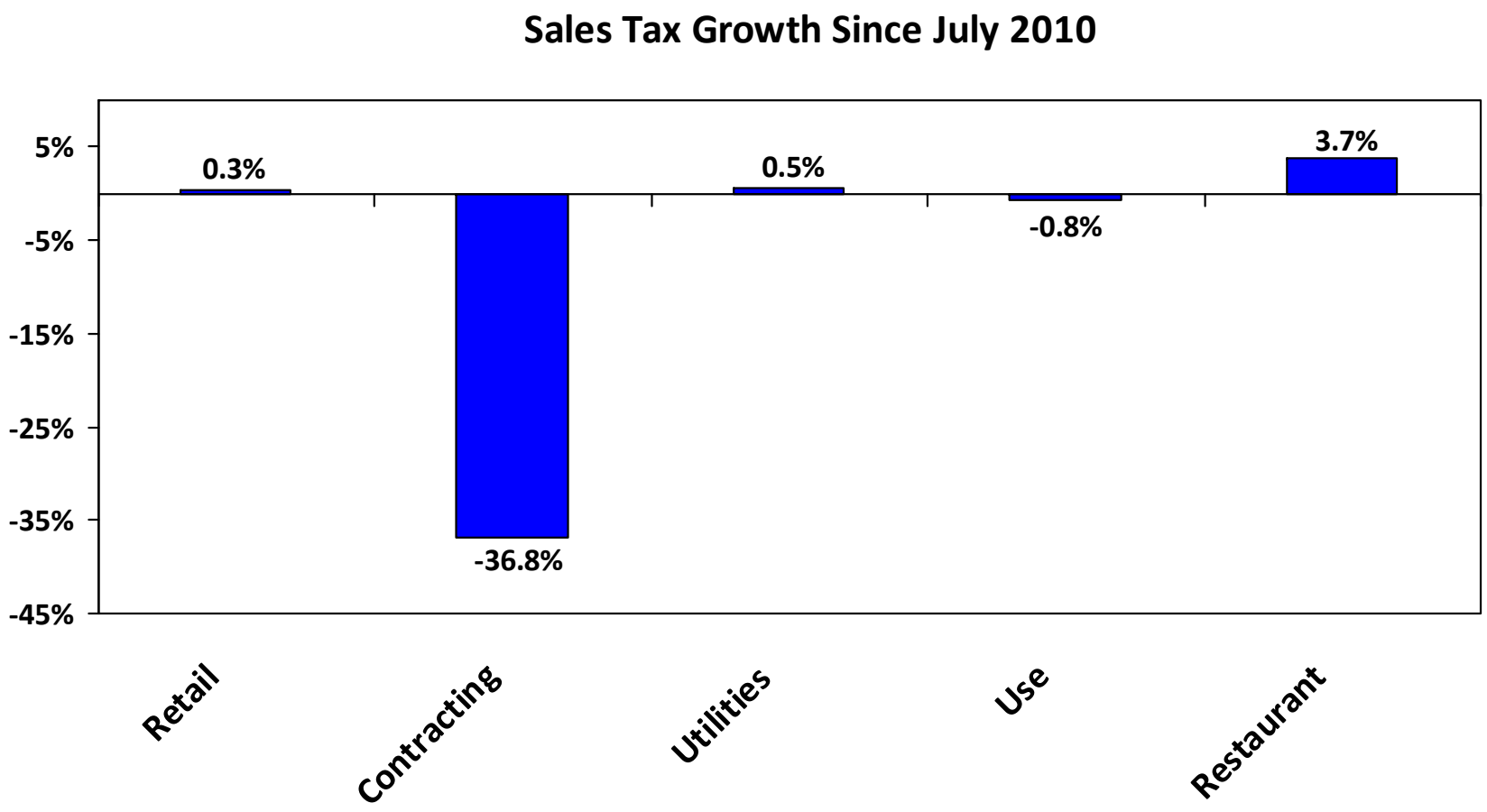
Sales Tax Collections by Category



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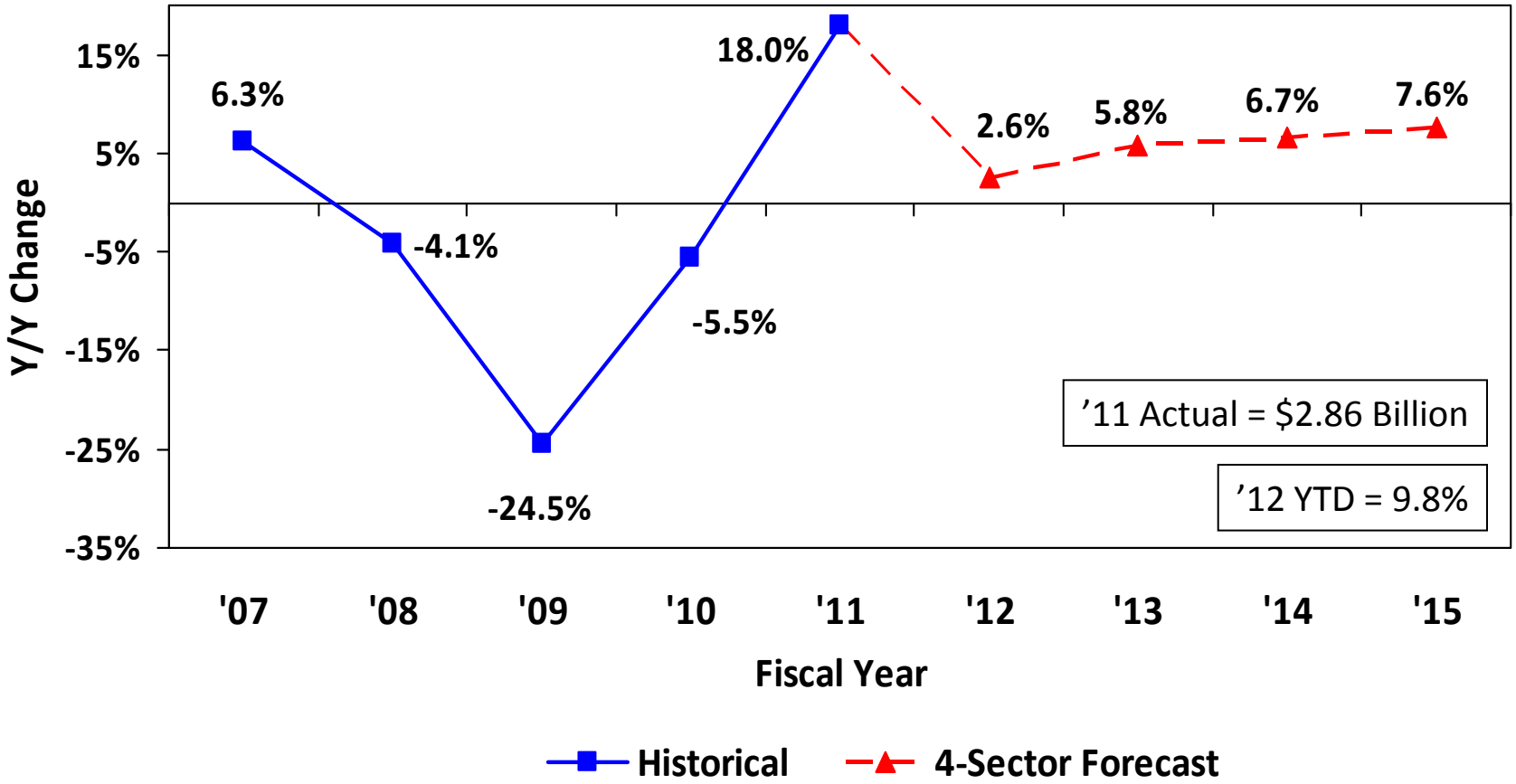
Percent Change in Adjusted Sales Tax Excluding 1-Cent Tax

Individual Income Tax

- The Consensus Forecasts Growth of 2.6% in FY ’12 and 5.8% in FY ’13



Percent Change in Base Revenue Excluding Tax Law and One-Time Changes

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Individual Income Tax Was Primary Reason For FY ’11 Forecast Overage

- Withholding grew 7.3% in FY ’11
  - Difficult to explain growth of this magnitude
  - Job growth was essentially flat
  - Average private wages grew 2 to 3%
  - Some growth may have come from change in Arizona withholding tables in July 2010
  - This may explain why 1st Quarter FY ’12 withholding growth moderated to 5.1%, the slowest growth in a year
- Strong State withholding growth appears to be part of a nationwide trend.
  - 8.3% nationwide growth in 1st quarter of 2011 (Jan. – Mar.)
  - May be that job and wage growth are underreported

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Higher Capital Gains and Loss of Mortgage Deduction Also Increased Income Tax Liability

- Tax Payments Grew By 13.3% and Refunds Fell By (9.6)% in FY ’11

- While no official data is available, capital gains probably grew substantially
  - Stock market values increased by 17% in calendar year 2010
  - “Flipping” of foreclosure properties produced some profits
- Fewer taxpayers are taking advantage of mortgage interest and property tax deduction
  - Arizona itemized deductions were down more than 20% in FY ’11
  - Reduction in itemized deductions added an estimated $200 million to FY ’11 net collections

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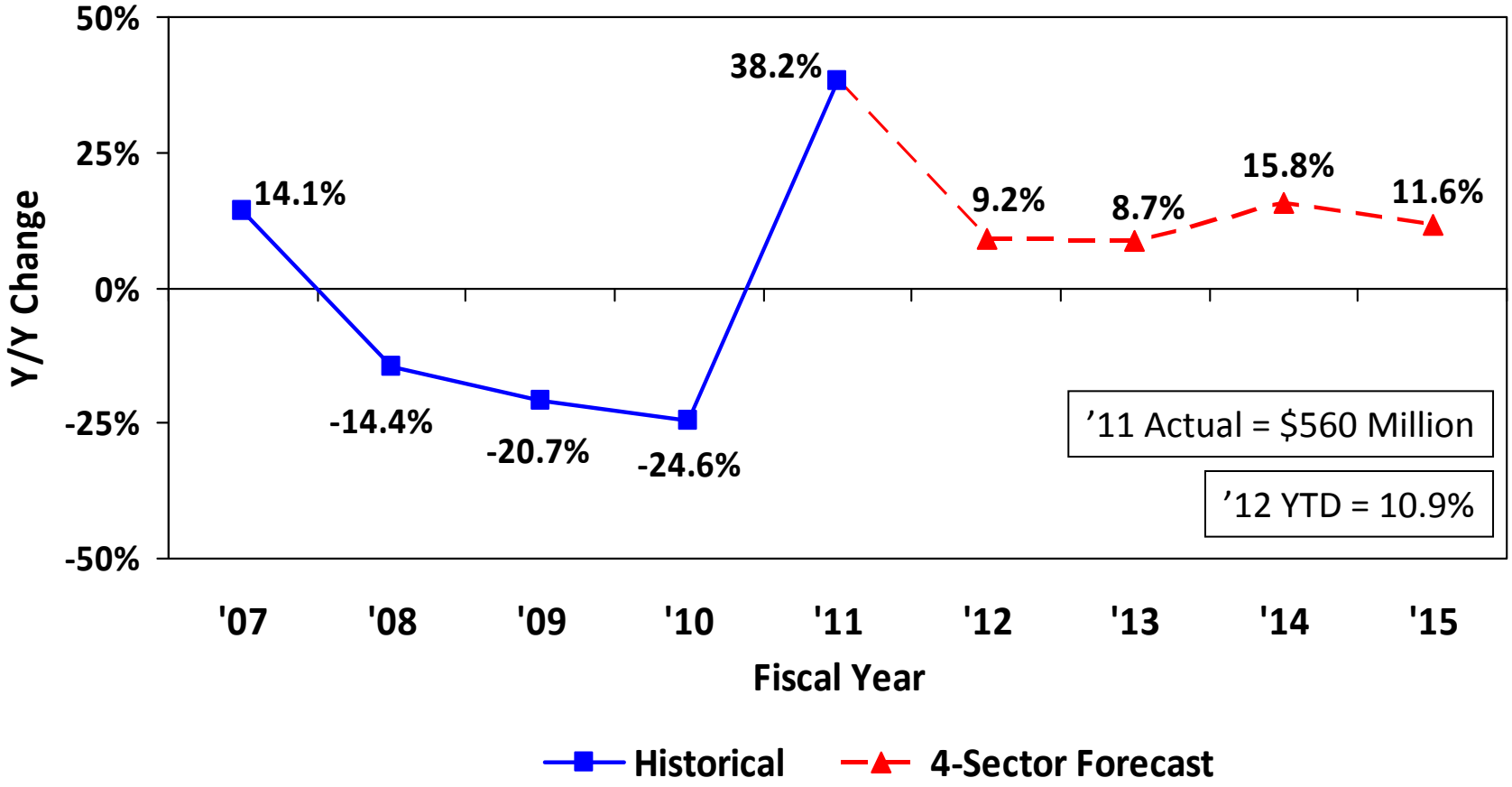
Corporate Income Tax

- The Consensus Forecasts Growth of 9.2% in FY ’12 and 8.7% in FY ’13



Percent Change in Base Revenue Excluding Tax Law Changes

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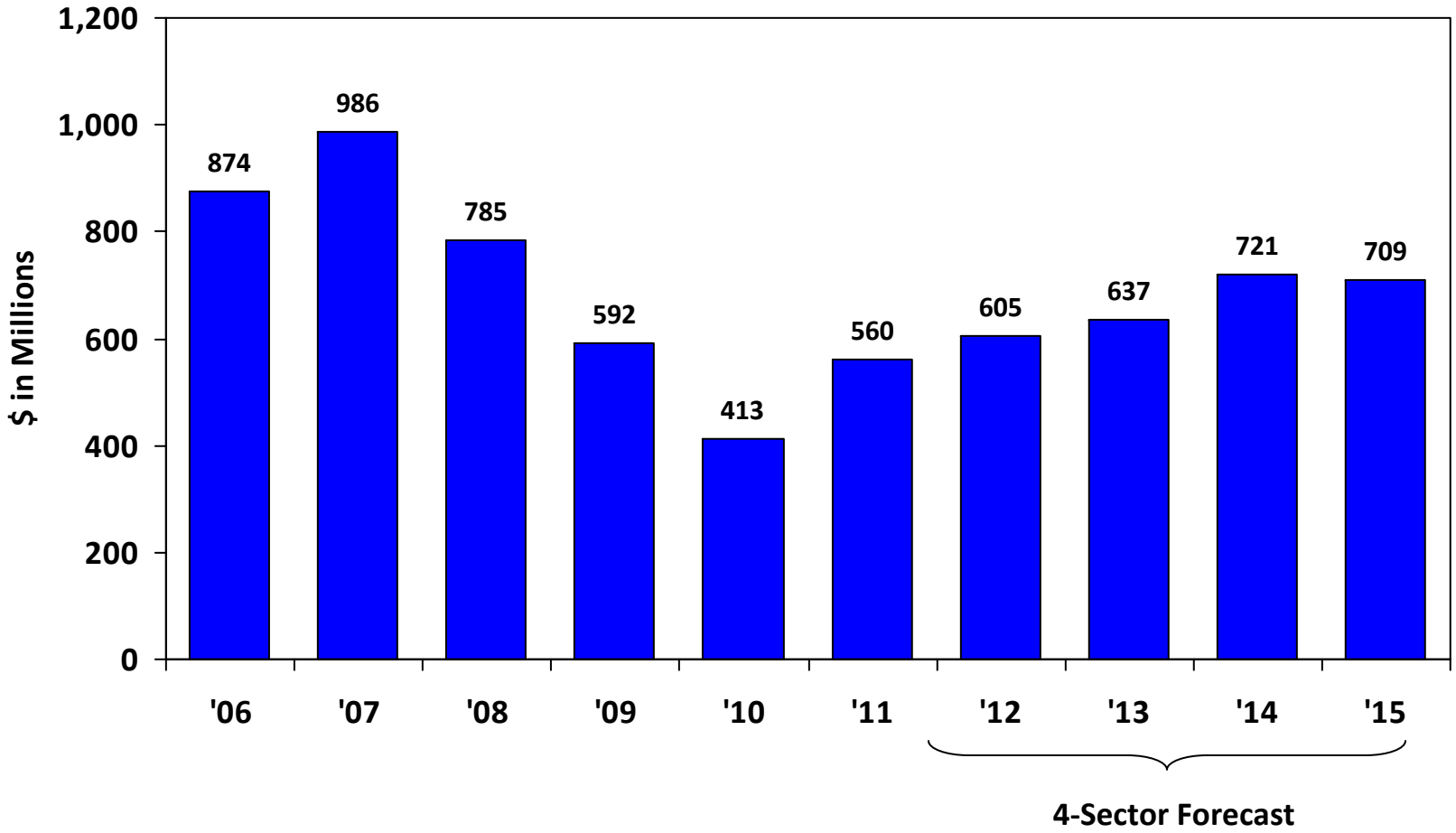
Corporate Income Tax

- Forecast Remains Substantially Below FY ’07 High Point



Includes enacted tax law changes and one-time adjustments.

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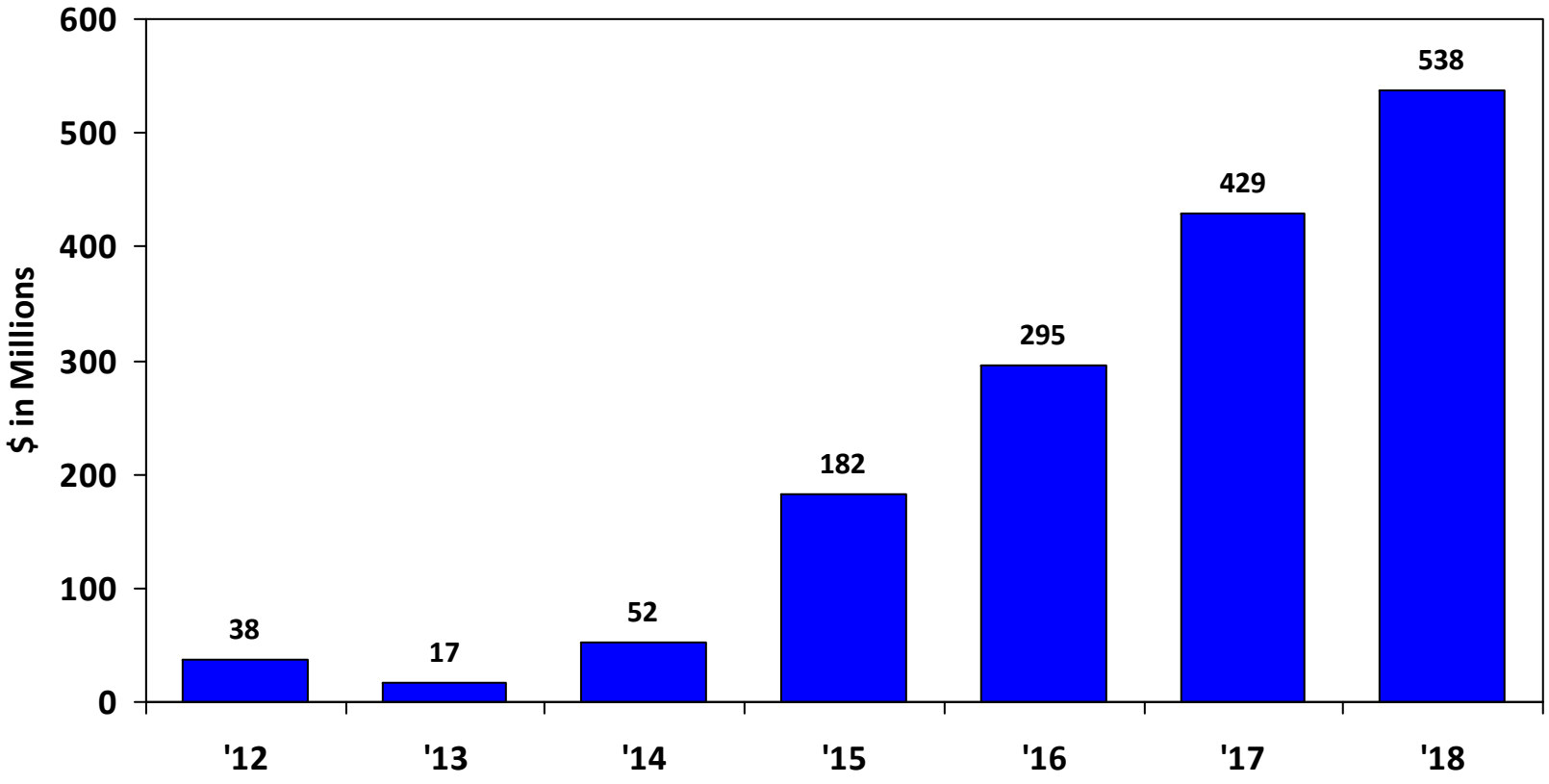
Enacted AZ Jobs Bill Will Not Have Major Fiscal Impacts Until FY 2015



Revenue Loss/Spending Increase Relative to Original FY 2012 Baseline Forecast

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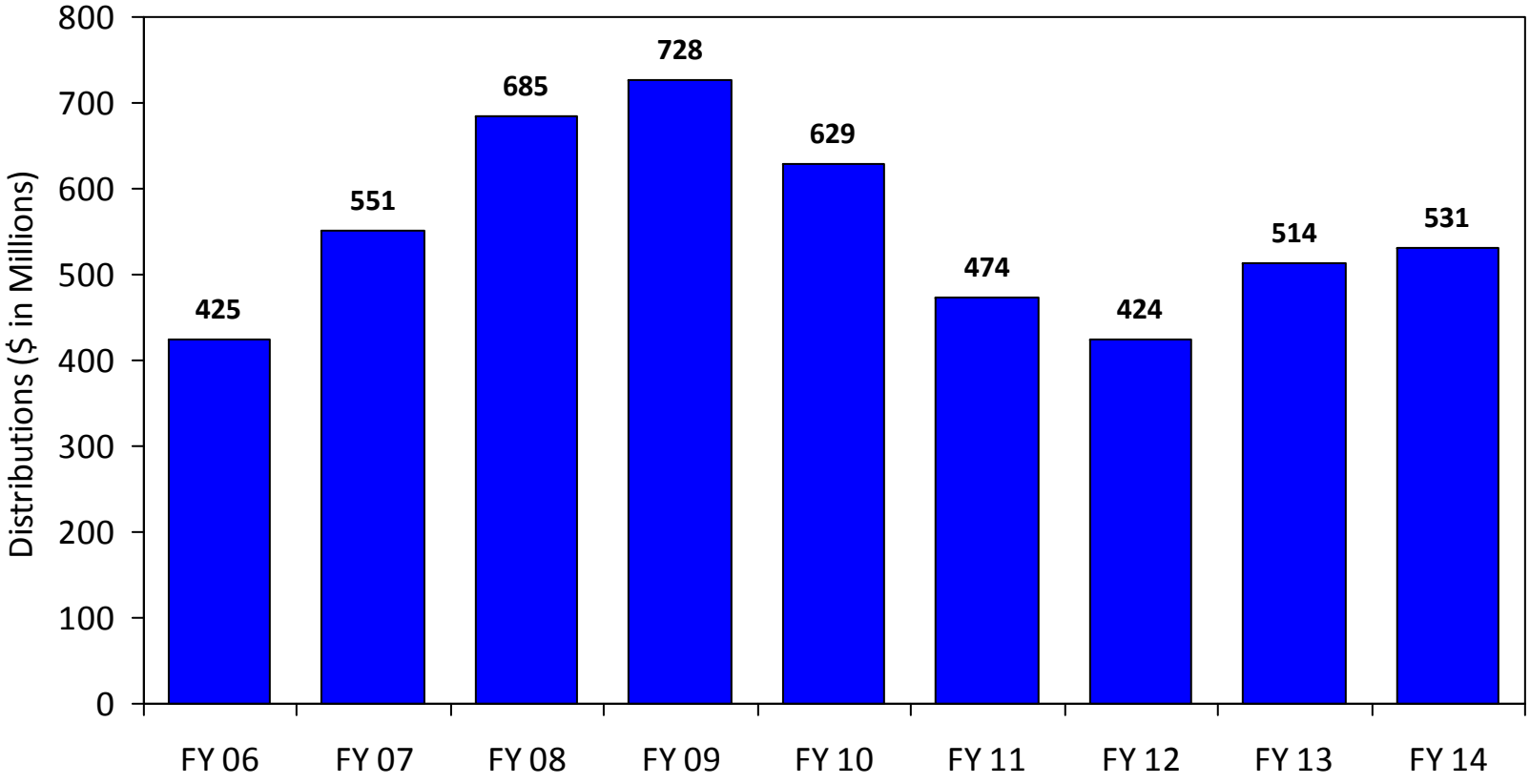
Income Tax Revenues Determine Urban Revenue Sharing

– Amount Linked to Income Tax Collections 2 Years Prior



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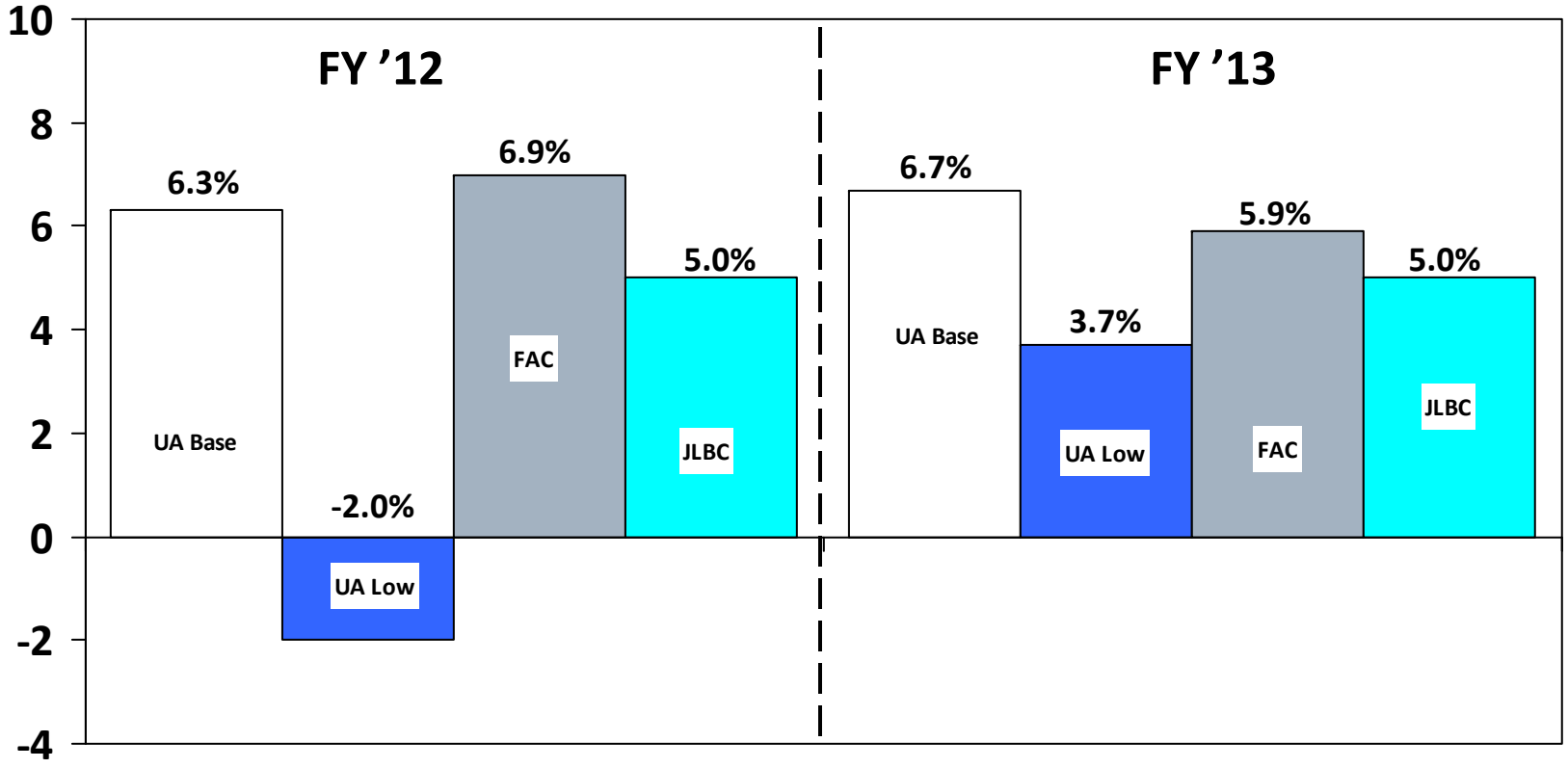
Consensus Predicts Base Growth Rate of 2.9% in FY ’12 and 4.9% in FY ’13*



Details in Appendix A

*** Weighted Big 3 average growth prior to 1-Cent sales tax is 4.0% in FY ’12 and 5.4% in FY ’13. After adjusting for small tax categories, the base growth rate is 2.9% in FY ’12 and 4.9% in FY ’13.**

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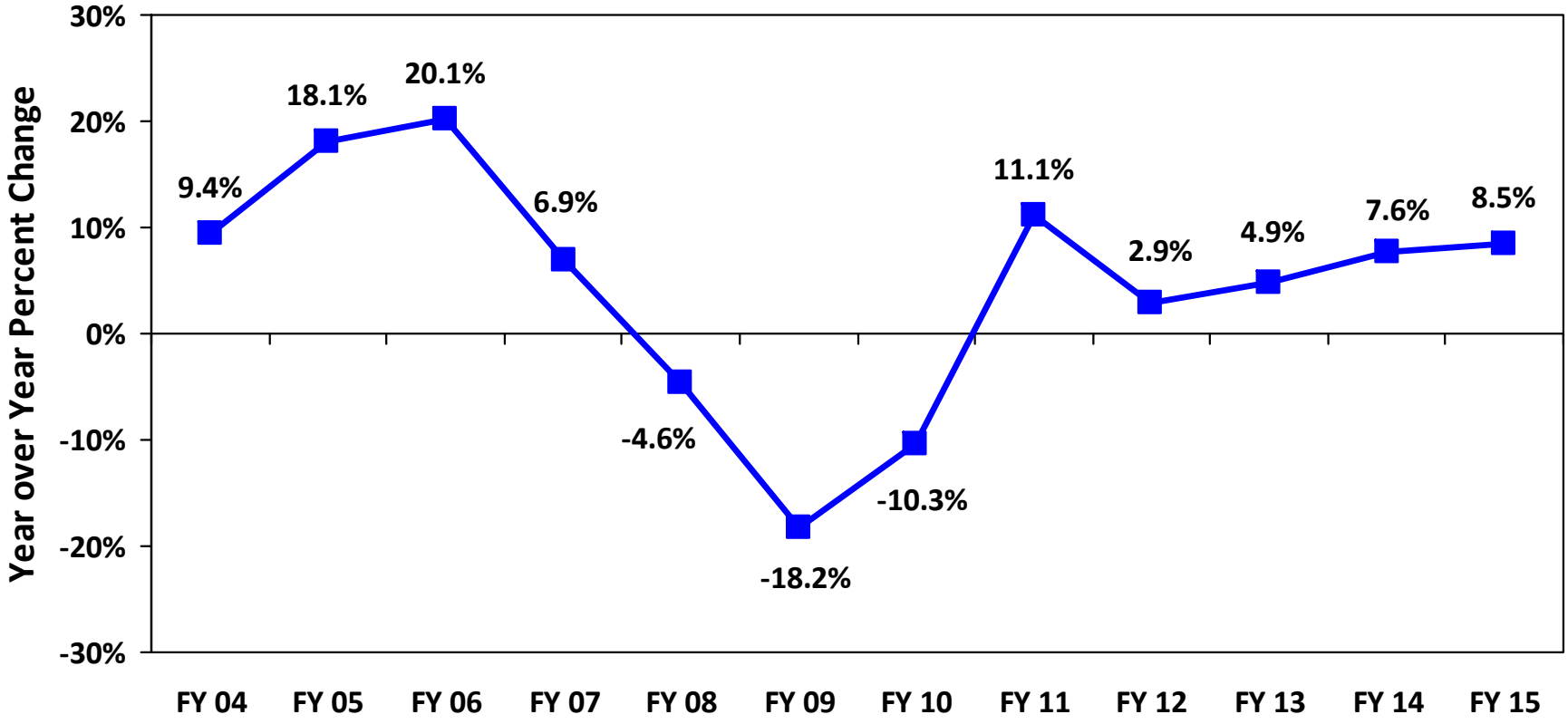
Consensus Forecasts Steadily Rising Revenue Growth Rate Through FY ’15



Percent Change in Base revenues excluding balance forward, tax law changes, one-time revenues, and urban revenue sharing

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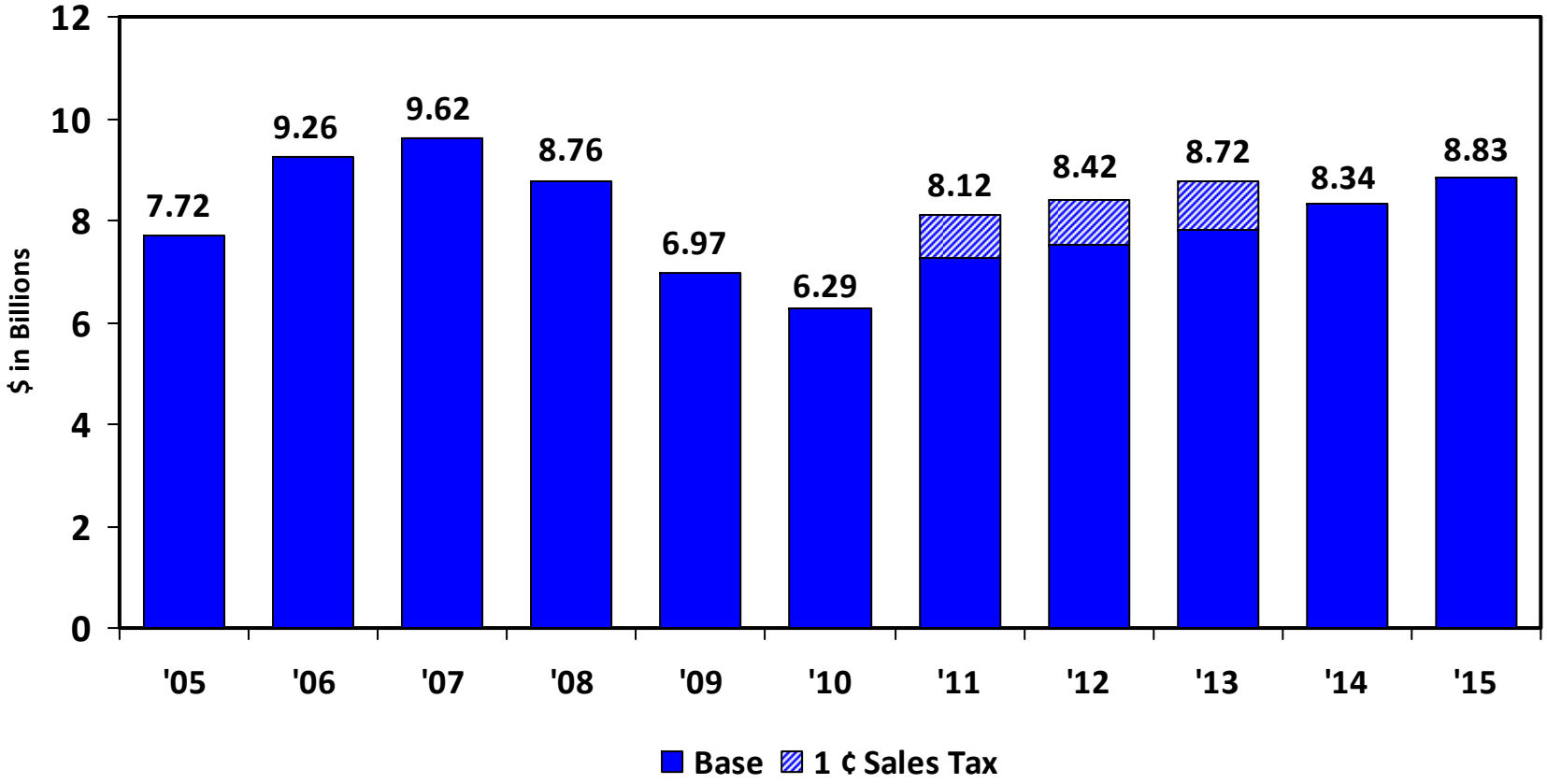
Consensus Forecasts Still Below FY ’07 Level



Excludes balance forward and other one-time revenues. Includes tax law changes and Urban Revenue Sharing.

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Consensus Forecast Poses Some Major Risks From A Budget Standpoint

- In short term, Consensus may not give adequate weight to recession scenario
  - Leading national forecasters place recession risk at 40% to 50%
- In the long term, Consensus assumes very strong growth in FY ’14 and FY ’15
  - Difficult to predict 3 years in advance and may result in false sense of optimism
- To address these concerns, the Baseline revenue projections have been modified
  - Add second “slow economy” scenario at rates 2% below Consensus
  - Consensus revenue growth rates for budgeting capped at 7% -- the prior long-term average

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The JLBC Staff Has Also Updated Its FY '12 – FY '15 Baseline Spending Estimates

- Based on active funding formulas and continued suspension of inactive formulas (See Appendix B)
  - The annual statutory suspensions save $730 M each year
  - Most savings involve K-12 operating formulas ($300 M) and School Facilities Board formulas resulting from '90s litigation ($400 M)
- Based on current law requirements of federal health care legislation beginning January 2014
  - Most Proposition 204 population becomes eligible again
  - Medicaid expands to 133% of poverty level – feds pay 100% in short-term
  - More currently eligible seek coverage, but federal match rate is higher

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Spending Issues Further Cloud Overall Budget Picture

- The State is subject to numerous "budget" lawsuits – such as freeze in Medicaid childless adult coverage and the K-12 inflator
- Federal budget negotiations may lead to reduction in State aid
- IRS requires State to use operating surplus above 5% ($400 M) to pay off "operating" issuances early
  - Represents a requirement of the State using tax-exempt financing for the $1.5 B state building sale/leaseback and lottery revenue bonds
  - Calculation is complex and final requirement is not known until ADOA releases an annual report six months after end of fiscal year
  - Preliminary estimate of this requirement in FY '12 is $72 M

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Given Revenue and Spending Risks, There Are 2 Baseline Budget Scenarios

- Scenario 1
  - Consensus revenue estimates
  - Active formula Baseline spending estimates
- Scenario 2
  - Substitutes “slow economy” revenue estimates
  - Same active formula spending, but adds $200 M if plaintiffs successful in budget lawsuits
- The 2 scenarios do not represent a lower and upper bound. Outside factors like the federal government could influence future budget projections.

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FY ’12 Budget Carryforward Could Be $415 M Under 1st Scenario and $130M in 2nd Scenario

- $332 M of FY ’12 revenues originally budgeted to pay off FY ’11 deficit – since FY ’11 ended up balanced, $ no longer needed
- April budget assumed FY ’12 base revenues would grow by 5.7% to $7.83 B
  - With higher than expected FY ’11 base, this level would be achieved with 1% growth in FY ’12
  - Based on slow economy and consensus projections, revenue could grow by 0.9% to 2.9%
- Net FY ’12 spending is projected to stay within budget, but litigation could result in supplementals

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FY ’12 Carryforward Balance Is One-Time

- Due to the expiration of the 1-cent sales tax at the end of FY ’13, budget is unbalanced in FY ’14
- Any use of short-term carryforward for new permanent revenue or spending changes in FY ’12 or FY ’13 would further increase future shortfalls
- But difficult to know magnitude of the carryfoward until much later in the fiscal year

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Detail of FY ’13 and ’14 Revenue Changes

Scenario 1 – Consensus Revenues	$ in Millions	
	FY ’13 Above FY ’12	FY ’14 Above FY ’13
Base Revenue Growth (4.9%/7.0%)	393	566
TPT $100K Threshold Expires	(52)	52
TPT 1 ¢ Expires	--	(905)
Elimination of One-Time Revenues - Fund Sweeps/County Contributions	(382)	--
AZ Commerce Authority Bill	(11)	(16)
Urban Revenue Sharing	(89)	(18)
Total	**(141)**	**(321)**

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Detail of the FY ’13 and ’14 General Fund Baseline Spending Adjustments

Scenario 1 – Active Funding Formulas	$ in M	
	FY ’13 Above FY ’12	FY ’14 Above FY ’13
K-12 Formula – Enrollment gains, limited inflation	29	39
AHCCCS/DHS – 5% Medicaid base growth, Federal and waiver addback in ’14	160	308
DES – DD Medicaid Growth	22	21
ADC – Marginal growth + phase-in of 5,000 new private beds in ’14	7	49
Debt Service	50	20
Extra Pay Period – One time savings	(79)	0
Other	(57)	(5)
Total	**132**	**432**

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FY ’12 – ’14 Budget Projections

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	12	13	14
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

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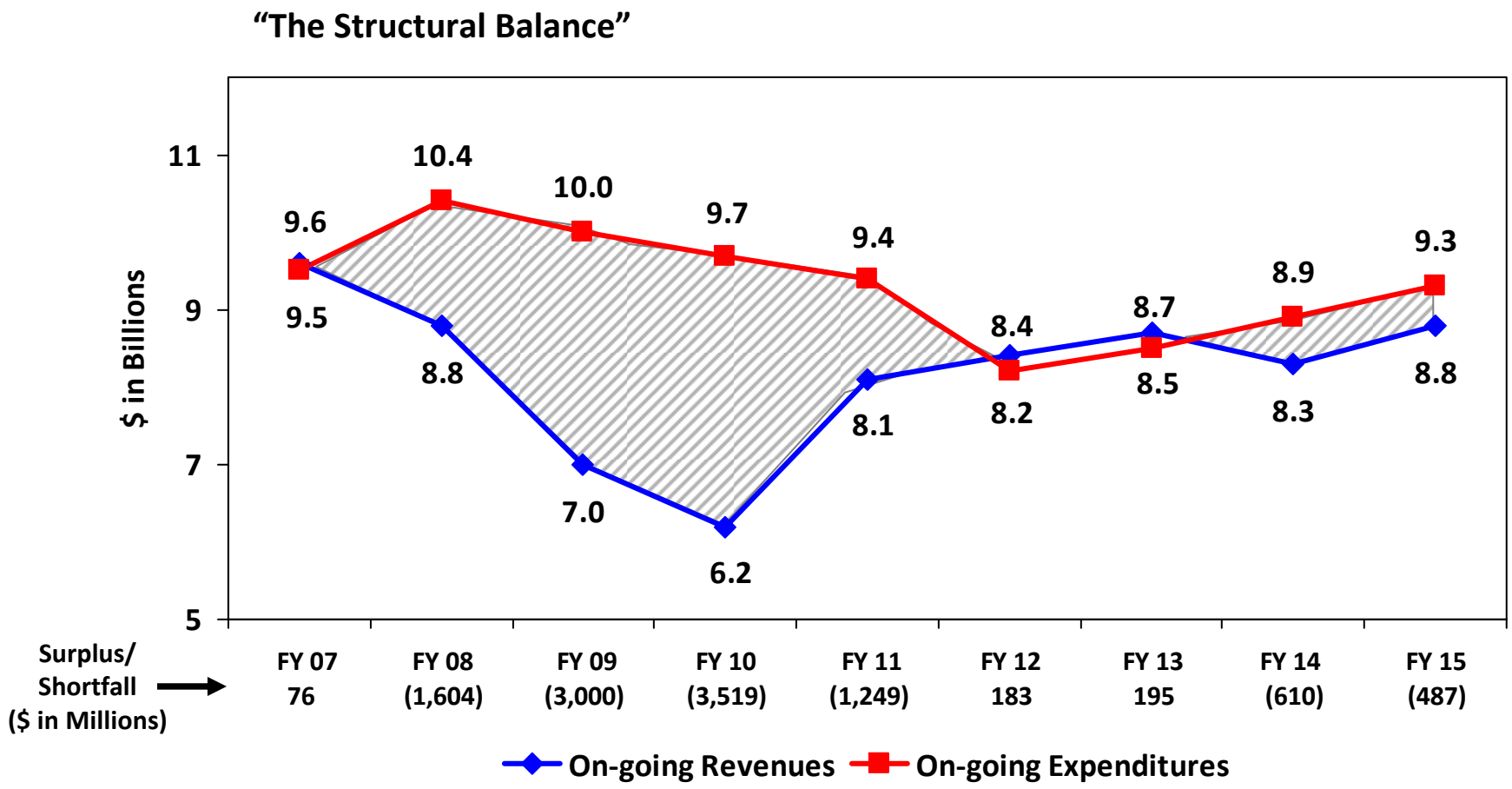
Under Scenario 1, Shortfall Re-emerges With Expiration of 1-Cent Sales Tax

- Consensus Revenues and Baseline Spending



Counts 1 ¢ TPT as on-going in FY '11 – FY '13

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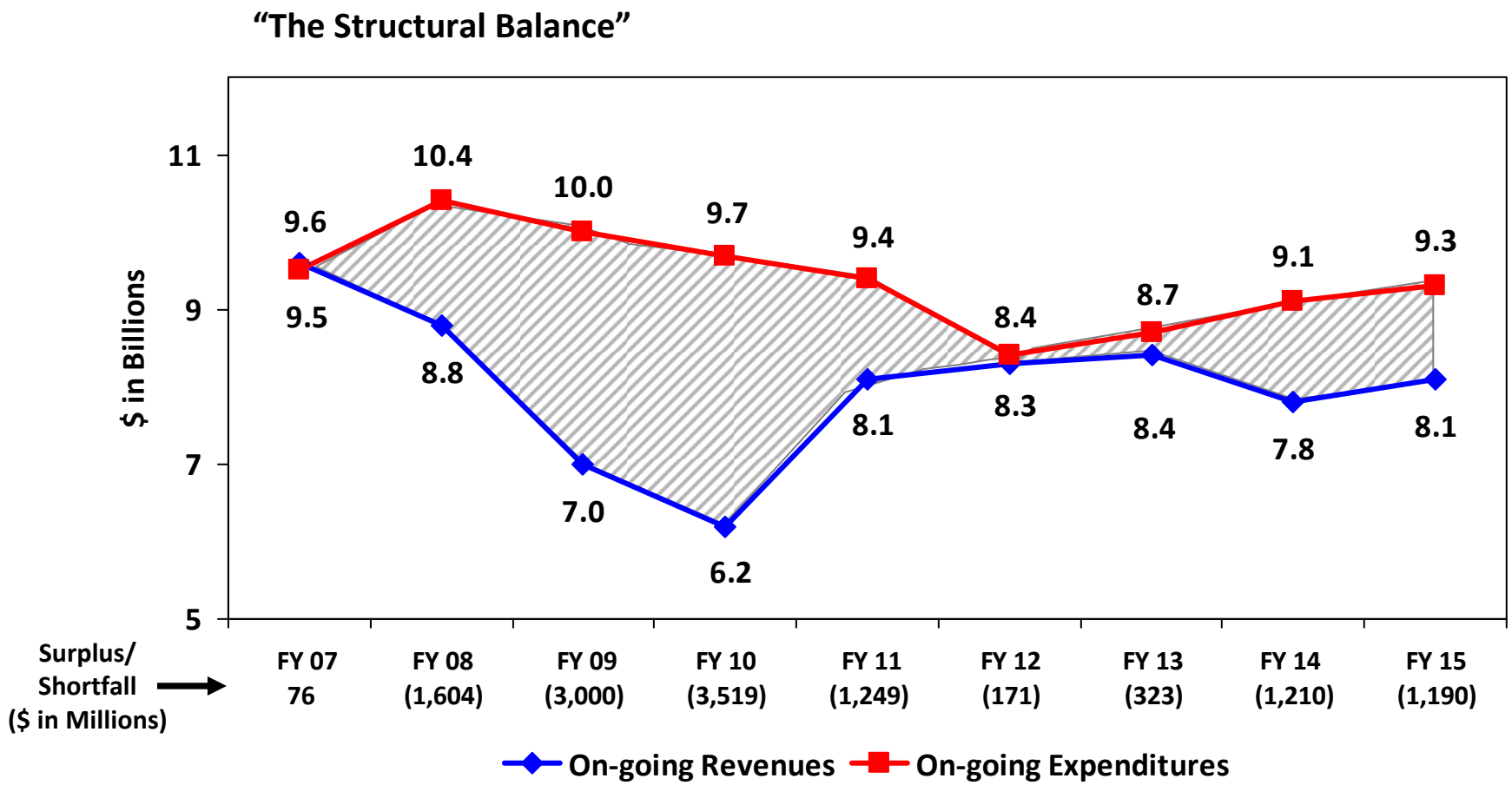
Under Scenario 2, FY ’14 Shortfall Grows to $(1.2) B
- Slow Economy and Plaintiff Litigation Verdicts



Counts 1 ¢ TPT as on-going in FY ’11 – FY ’13

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Summary of the Budget Outlook

- Since FY ’11 shortfall no longer has to be paid off with FY ’12 revenues, state will likely generate a carryforward balance at the end of FY ’12
- Projected FY ’12 carryforward balance is $130 M or $415 M under 2 scenarios - but estimates are not reliable at this time due to economic uncertainty and pending litigation.
- Using FY ’12 balance for any new permanent revenue decrease or spending increase would increase future year shortfalls.
- It is unclear whether the FY ’13 budget will be in balance or have a projected shortfall. With expiration of 1 cent sales tax, however, we would incur a FY ’14 shortfall of $600 M (Scenario 1) or $1.2 B (Scenario 2).
- 3 Year estimates are highly speculative - small changes in growth rates could result in a balanced budget in FY ’14 or a $(1.7) B shortfall.

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Appendix A: October 2011 4-Sector Forecast

	FY 2012	FY 2013	FY 2014	FY 2015
Sales Tax				
JLBC Forecast	5.2%	5.0%	7.0%	7.0%
UA – Low	1.5%	2.1%	6.8%	11.0%
UA – Base	5.0%	5.2%	7.4%	10.3%
FAC	6.0%	5.4%	6.5%	6.6%
Average:	**4.4%**	**4.4%**	**6.9%**	**8.7%**
Individual Income Tax				
JLBC Forecast	5.6%	5.1%	7.0%	7.0%
UA – Low	-6.9%	4.9%	6.5%	8.9%
UA – Base	5.2%	7.3%	6.8%	7.9%
FAC	6.3%	5.8%	6.6%	6.9%
Average:	**2.6%**	**5.8%**	**6.7%**	**7.6%**
Corporate Income Tax				
JLBC Forecast	0.7%	4.6%	7.4%	7.5%
UA – Low	0.9%	8.3%	23.4%	20.4%
UA – Base	20.5%	11.7%	22.4%	12.1%
FAC	14.5%	9.6%	9.1%	5.9%
Average:	**9.2%**	**8.7%**	**15.8%**	**11.6%**
JLBC Weighted Average:	**5.0%**	**5.0%**	**7.0%**	**7.0%**
UA Low Weighted Average	**-2.0%**	**3.7%**	**8.1%**	**11.0%**
UA Base Weighted Average	**6.3%**	**6.7%**	**8.6%**	**9.5%**
FAC Weighted Average:	**6.9%**	**5.9%**	**6.8%**	**6.7%**
"Big-3" Weighted Average	**4.0%**	**5.4%**	**7.6%**	**8.5%**
Consensus Weighted Average:*	**2.9%**	**4.9%**	**7.6%**	**8.5%**
Adjusted Consensus Weighted Average:**	**2.9%**	**4.6%**	**7.2%**	**7.3%**

* Consensus Big-3 Categories adjusted for small revenue categories

** Consensus Weighted Average adjusted for tax law changes

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Appendix B: Funding Formula Suspensions

Statutory Funding Formula Suspensions*

Agency	Formula	FY 2013 Cost If Funded
Community College	Capital State Aid Suspension	$23,844,200
Department of Education	Soft-Capital Formula	$188,120,700
	Charter School Additional Assistance	$17,656,000
	Capital Outlay Revenue Limit (CORL)	$63,684,600
	Fund JTEDs at 91%	$4,849,100
Department of Emergency & Military Affairs	Governor's Emergency Fund	$1,100,000
Department of Environmental Quality	WQARF	$8,000,000
Department of Health Services	Restoration to Competency	$1,740,600
	SVP	$2,670,300
School Facilities Board	Building Renewal	$249,681,800
Tourism	Tourism Funding Formula	$15,545,400
Universities	Financial Aid Trust	6,106,400
Subtotal		**$582,999,100**
Future Year Cost – School Facilities Board	New School Construction (If enrollment returns to pre-recession level)	$150,000,000
Total		**$732,999,100**

Non-Statutory Formula Suspensions

Department of Administration	Building Renewal	$27,580,000
Universities	General Fund Enrollment	$39,764,200
	Building Renewal	$97,630,700
Subtotal		**$164,974,900**

*** Excludes AHCCCS suspensions.**

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