Finance Advisory Committee

Revenue and Budget Update

October 7, 2014

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Summary of Current Budget Status

- At the end of May, the projected current year ('15) ending balance was $130 M – but '16 had a $(237) M shortfall
- Revenue growth has slowed considerably in the interim, and the new forecast is more cautious
- As a result, shortfalls are now projected in both years:
  - $(189) M in '15 and $(667) M in '16
- The Superior Court K-12 inflation ruling would further increase the budget gap:
  - $(520) M in '15 and $(1.0) B in '16

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Implications of FAC Update and K-12 Litigation

- Does Not Reflect Impact if Litigation Back Payments Are Awarded

Potential Ending Balance Estimates
$ in M

After:	FY '15	FY '16
• May Special Session	$130	$(237)
• October FAC Update	(189)	(667)
• FAC Update + K-12 Reset	(520)	(1,002)

- Estimates assume that '15 shortfall is resolved with 1-time solutions prior to '16

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The Caveats

- ‘14 again demonstrated the challenge in forecasting revenues accurately
  - 1% error across 3 years changes balance by $575 M
- AZ revenue performance at odds with recent favorable US economic news
  - If national momentum is sustained, there is upside potential for AZ by Spring
  - But shortfalls would still remain

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What Has Happened Since the May Special Session?

‘14 Revenue Below Forecast in 3 Main Categories

- Includes Statutory Revenue Changes

	‘14 Budgeted	‘14 Actual
Sales	5.7%	5.5%
Individual Income	3.7%	1.9%
Corporate Income	(3.5)%	(13.1)%

- Overall ‘14 base revenue growth was 3.1%, or 2.7% after statutory changes
- Second half was weaker: 1.5% vs 3.8% in first 6 months
- ‘14 revenues were $(86) M short of forecast
- Lower ‘14 base reduces subsequent years

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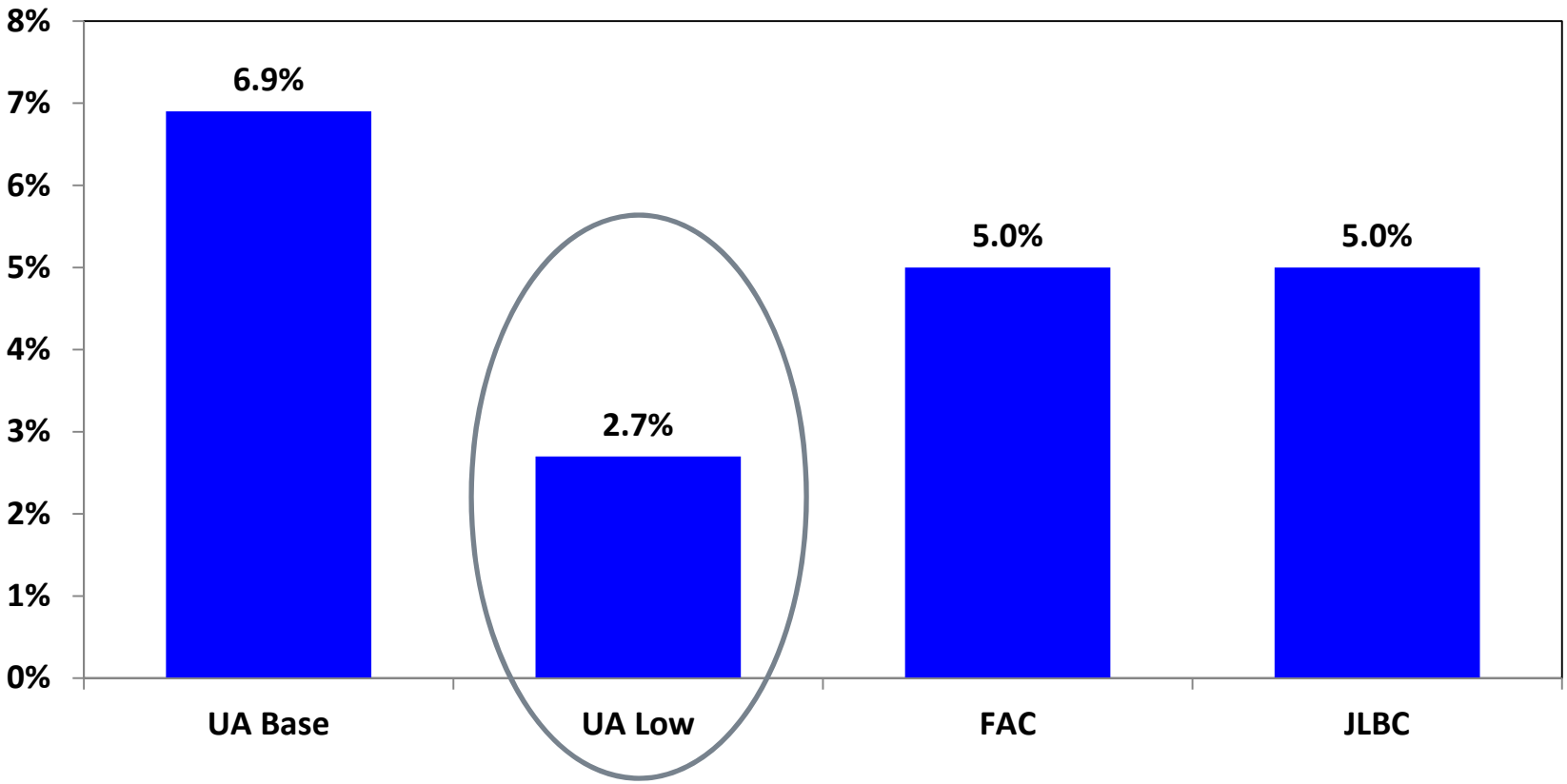
Predicting 3.1% '14 Growth

- UA Low Forecast was the Closest



April 2013 Forecast

Modified for Small Categories

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1st Qtr '15 Growth Was 3.0%

- $(65) M Below Forecast

	1st Qtr % Change
Sales Tax	2.3%
Individual Income Tax	2.4%
Corporate Income Tax	7.8%
Overall	3.0%

- With preliminary September estimates, revenues have been below forecast for 6 consecutive months

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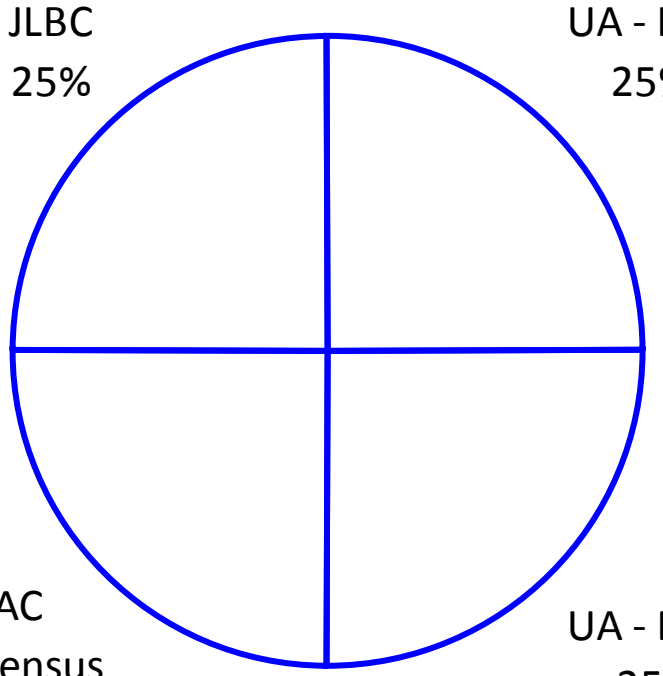
Revenue Forecast

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:

- FAC average
- UofA model – base
- UofA model – low
- JLBC Staff forecast
- Remaining revenues (8% of total) are staff forecast



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

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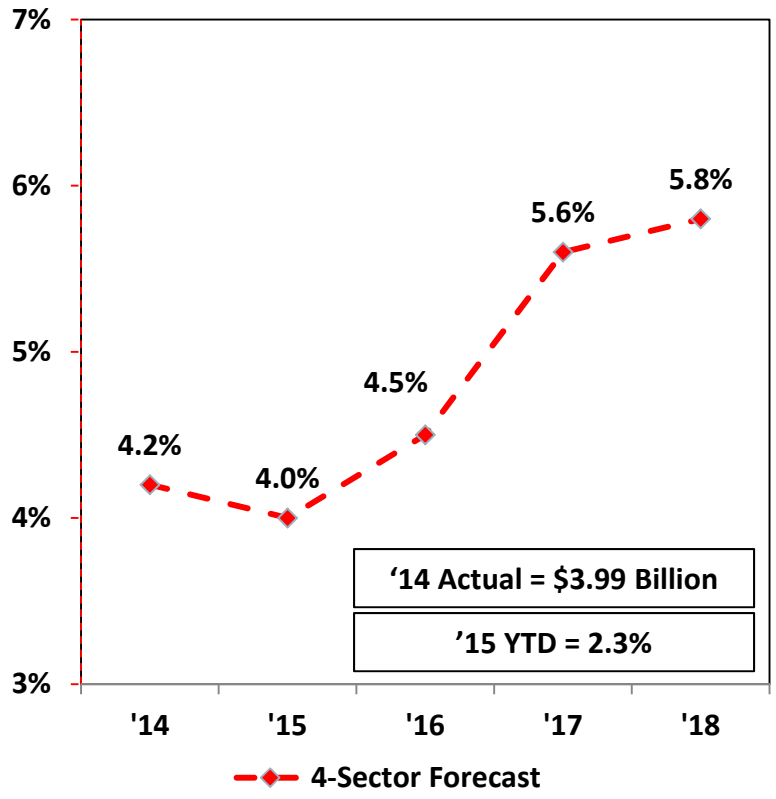
Sales Tax
- Projected Growth of 4.0% in ’15 and 4.5% in ‘16



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

- Retail up 6.2% in ‘14; 3.7% so far in ‘15
- Contracting up 11% in ‘14; near flat in 1st Qtr ‘15
- Overall, 2.3% 1st Qtr was weak
- Will Jan ‘15 contracting law have an impact?

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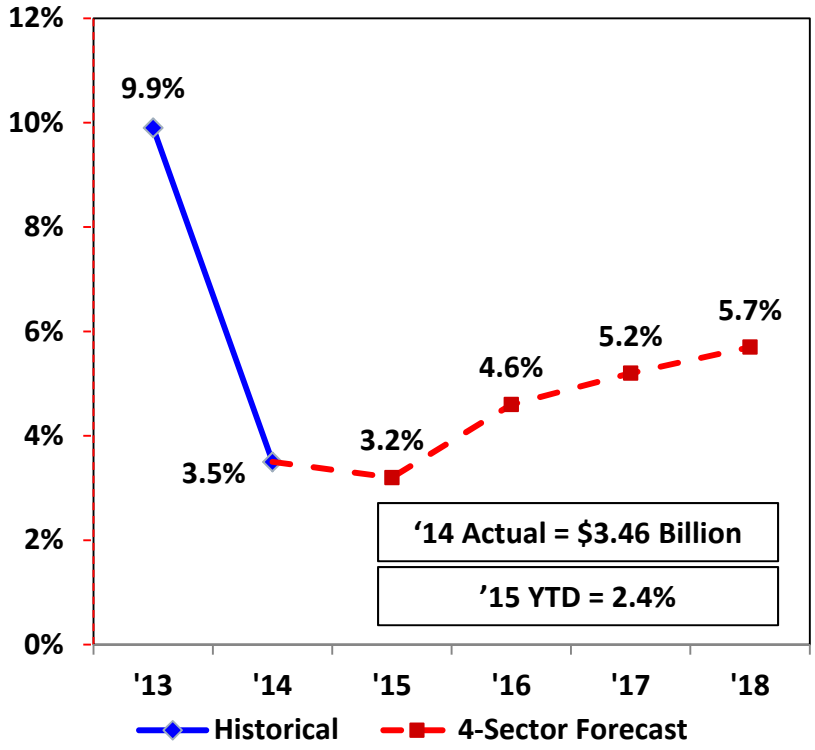
Individual Income Tax
- Projected Growth of 3.2% in ’15 and 4.6% in ‘16



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

- “Fiscal cliff” fueled ‘13 growth
- Acceleration of gains primarily lowered ‘14 collections
  - Plus some ‘15 & ‘16 impact
- Weak job and salary growth led to only 3.4% withholding gain in ’14
- 1st Qtr ‘15 withholding was more disappointing: 1.4%
- S&P 500 up 7% since January; April ‘15 “surprise”?

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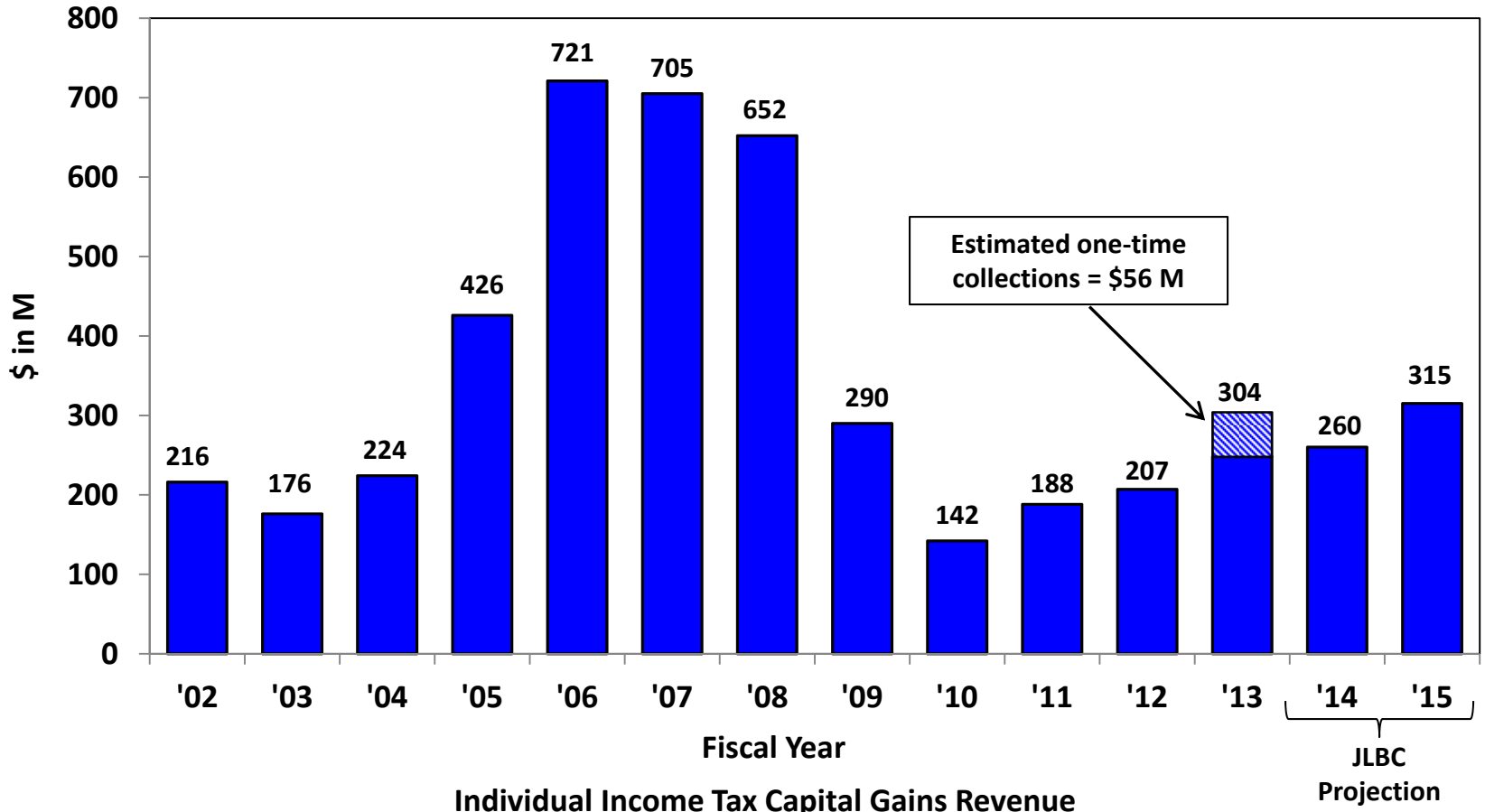
Capital Gains Complicate Income Tax Forecasting



Individual Income Tax Capital Gains Revenue
'14 and '15 Not Adjusted for Tax Law Changes

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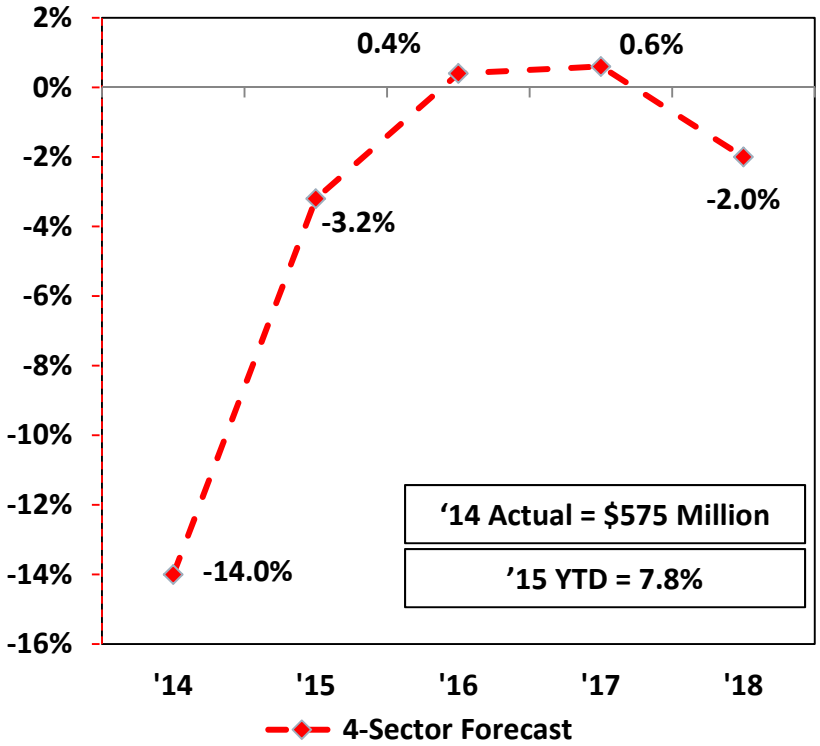
Corporate Income Tax
- Projected Growth of (3.2)% in ’15 and 0.4% in ’16



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

- US corporate profits up 5% but AZ ‘14 collections declined
- Credit use has been growing – but no data after TY ‘11
- 25% of ‘14 refunds were from prior to TY ‘10

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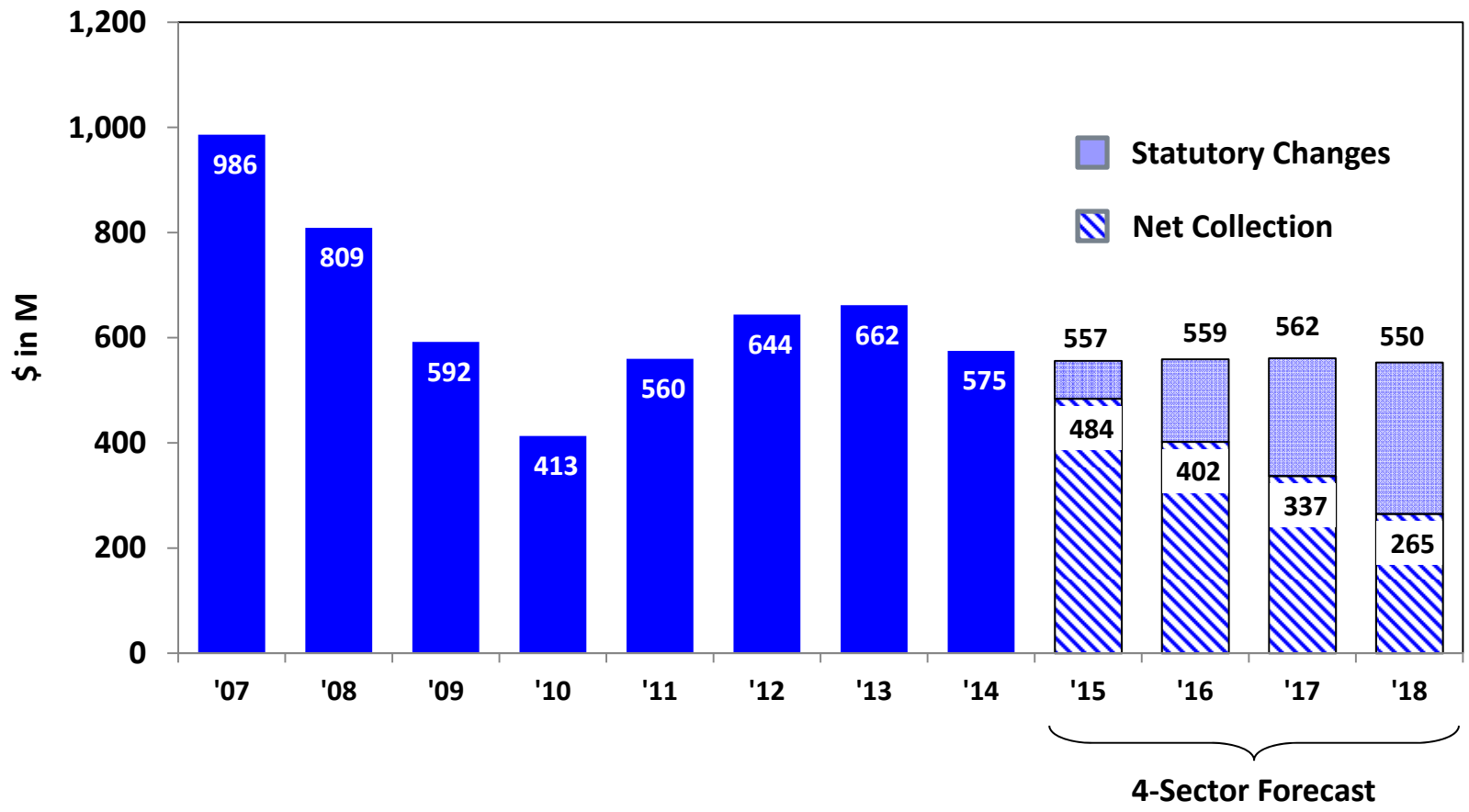
‘18 CIT Projected to be $265 M

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



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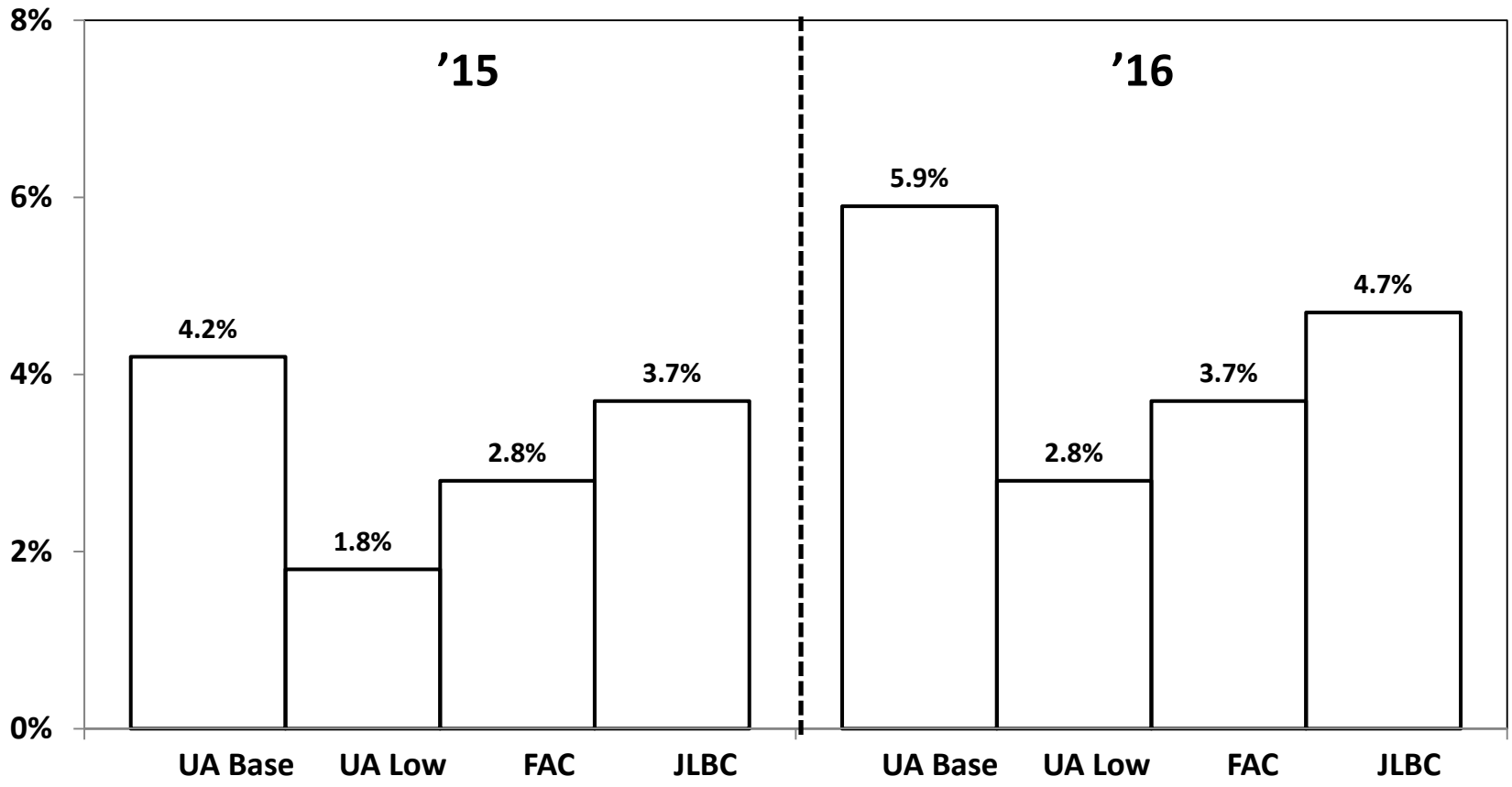
Overall Consensus Growth Rate

- 3.4% in ’15 and 4.1% in ’16



Details in Appendix A

Prior to adjusting for small tax categories, the Big 3 base growth rate is 3.1% in ’15 and 4.3% in ’16

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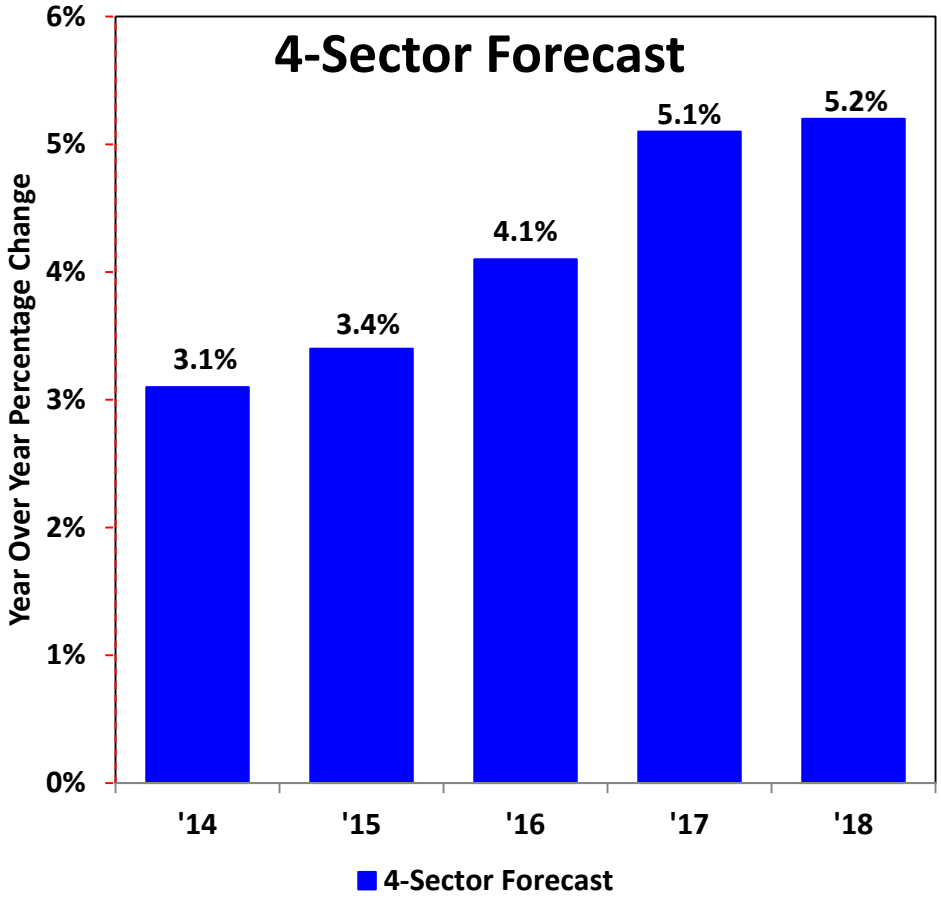
Growth Reaches 5% Again in '17 & '18



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

- Was '14 an outlier or a precursor?
- 3.0% 1st Qtr '15 Growth
- Higher-than-average chance that forecast improves by Spring

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Components of the Revenue Forecast

- Excludes Change in Beginning Balance

		$ in M	
4 Sector Consensus	’16	’17	’18
Base Revenue Growth (4.1%/5.1%/5.2%)	372	479	517
Elimination of Fund Transfers	(54)	--	--
Previously Enacted Tax Legislation	(100)	(61)	(65)
Urban Revenue Sharing	3	2	(9)
Total	**221**	**420**	**443**
% Change	**2.6%**	**4.8%**	**4.8%**

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Phase-In of $226 M of Enacted Tax Reductions

	$ in M		
	‘16	‘17	‘18
Corporate Rate Reduction/Sales Factor	(57)	(50)	(48)
25% Capital Gains Reduction	(12)	0	0
1-time Income Tax Indexing	(6)	6	0
Corporate School Tuition Indexing	(9)	(10)	(12)
Other	(16)	(7)	(5)
Total	**(100)**	**(61)**	**(65)**

By ‘18, revenue base is forecast to be a total of $226 M lower than if no enacted changes

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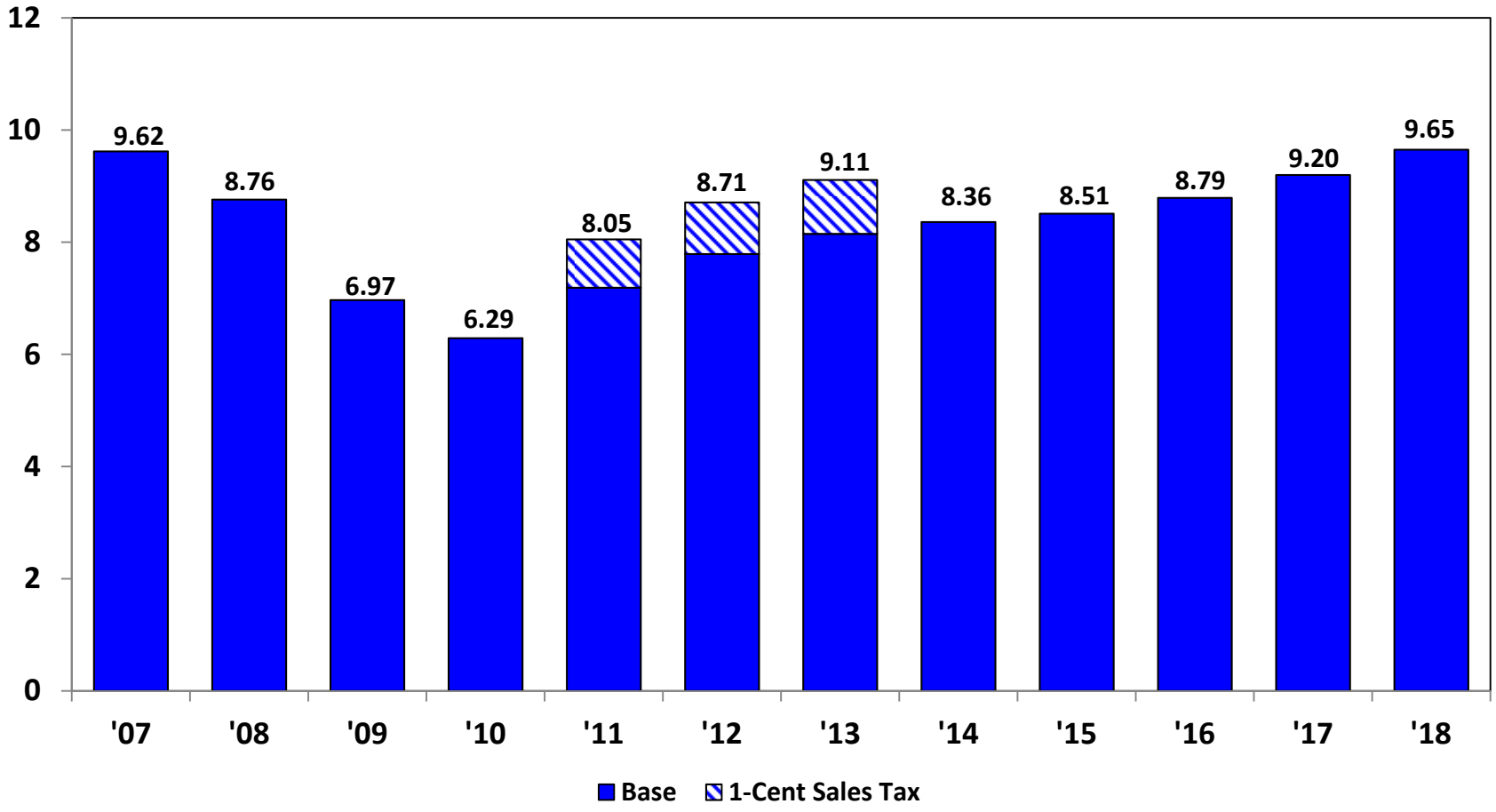
The Last Decade of General Fund Revenues



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

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Spending Forecast

Updated '16 – '18 Spending Projections

- Enacted budget figures have been updated to reflect latest estimated changes to currently active statutory and other funding formulas
- Spending estimates assume the continued annual suspension of $374 M of inactive formulas – mostly ADE funding
- Assumes continuation of $1.2 B in "rollover" payments
- Assumes no discretionary spending increases

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Projected Spending Changes

	$ in M		
	’16	’17	’18
K-12 Formula	175	209	162
Medicaid Formula	57	117	131
DCS 1-Time Backlog	(11)	(8)	0
ADC Operating	8	(1)	0
Capital	(45)	0	0
HURF Shift ($30 M to $60 M)	0	30	0
One-Time/Other	(62)	(6)	3
Additional Spending	**122**	**341**	**296**
Total Spending	**$9,451**	**$9,792**	**$10,088**
K-12 Inflation Reset	**$336**	**$341**	**$346**
Revised Total	**$9,787**	**$10,133**	**$10,434**

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Main Caseload Assumptions

- Before "reset", K-12 would grow by $175 M
  - '16 inflation/student growth/property tax cut
- Medicaid '16 spending only grows 2.9%
  - Better federal match rates
- DCS 1-time funding removed
- ADC reflects annualized cost for opening 1,000 new beds

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Status of K-12 Inflation Litigation

- In ‘09 – ‘13, State did not fully inflate K-12 formula
- AZ Supreme Court has ruled that full inflation is required
- In response, State fully inflated in ‘14 and ‘15, but made no retroactive adjustments
- Case returned to Superior Court to determine whether other adjustments are required

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What Is Potential Cost of K-12 Litigation?

- Plaintiffs requested a $236 per student increase to reset the formula as if inflation was always fully funded
  - Also seeking $1.3 B of retroactive payments
- Resolution could take a year – depends on appeals
- The Superior Court concurred with plaintiffs' position but scheduled an October hearing to consider back payments
- "Reset" cost updated to $336 M since some "zero-aid" districts would qualify for state funding

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Projected Ending Balance Estimates

Updated ’15 – ’18 Ending Balance Projections

- October FAC Revenue With Updated Agency Caseload

Baseline	’15	’16	’17	’18
Balance Forward	$577 M	--	--	--
Revenues	$8.56 B	$8.78 B	$9.20 B	$9.65 B
Spending	$9.66 B	$9.79 B	$10.13 B	$10.43 B
Ending Balance	**$(520) M**	**$(1.0) B**	**$(928) M**	**$(787) M**

- Includes $336 M K-12 inflation reset
- Without reset, ’15 shortfall is $(189) M and ’16 is $(667) M
- Does not include $460 M Rainy Day Fund

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Solutions to $(520) M '15 Gap Affect '16

	'16 Shortfall $ in M
If '15 solutions one-time	(1,002)
If '15 solutions permanent	(482)
If no '15 solutions	(1,522)

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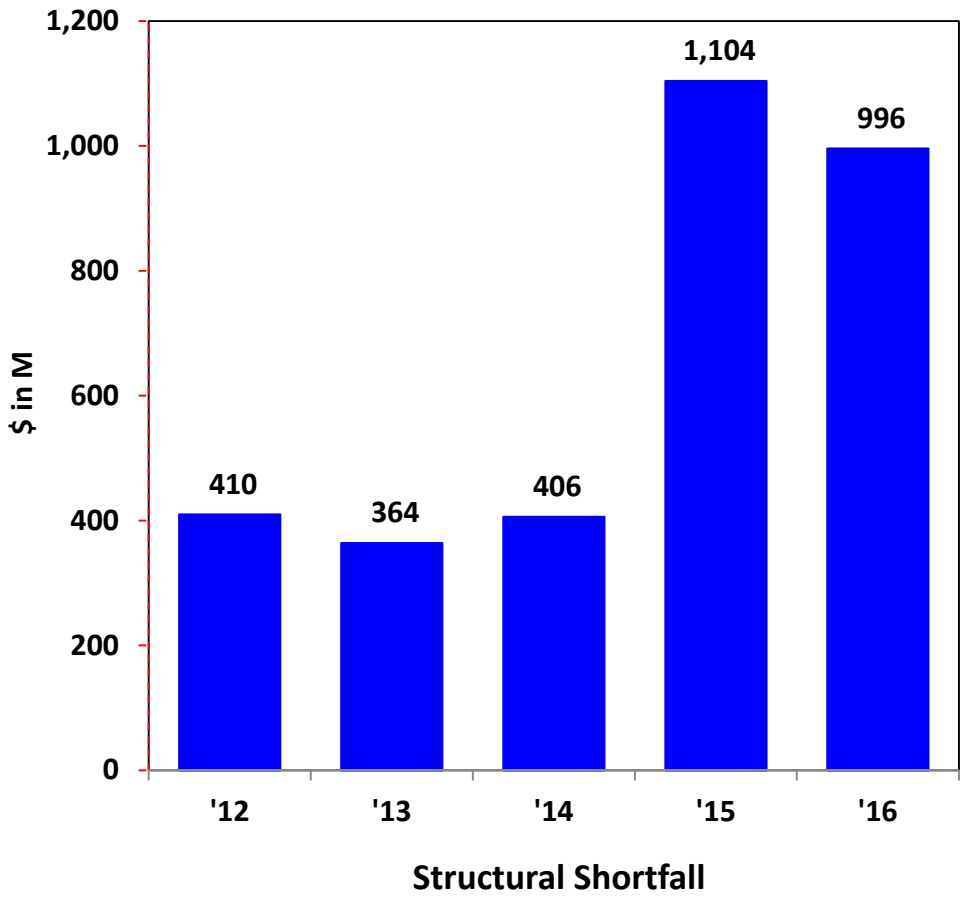
The Ongoing Structural Shortfall Helped Create the Current Problem



- Reflects only ongoing revenue and spending
- 1-cent sales tax and carryforward kept '12-'14 balanced

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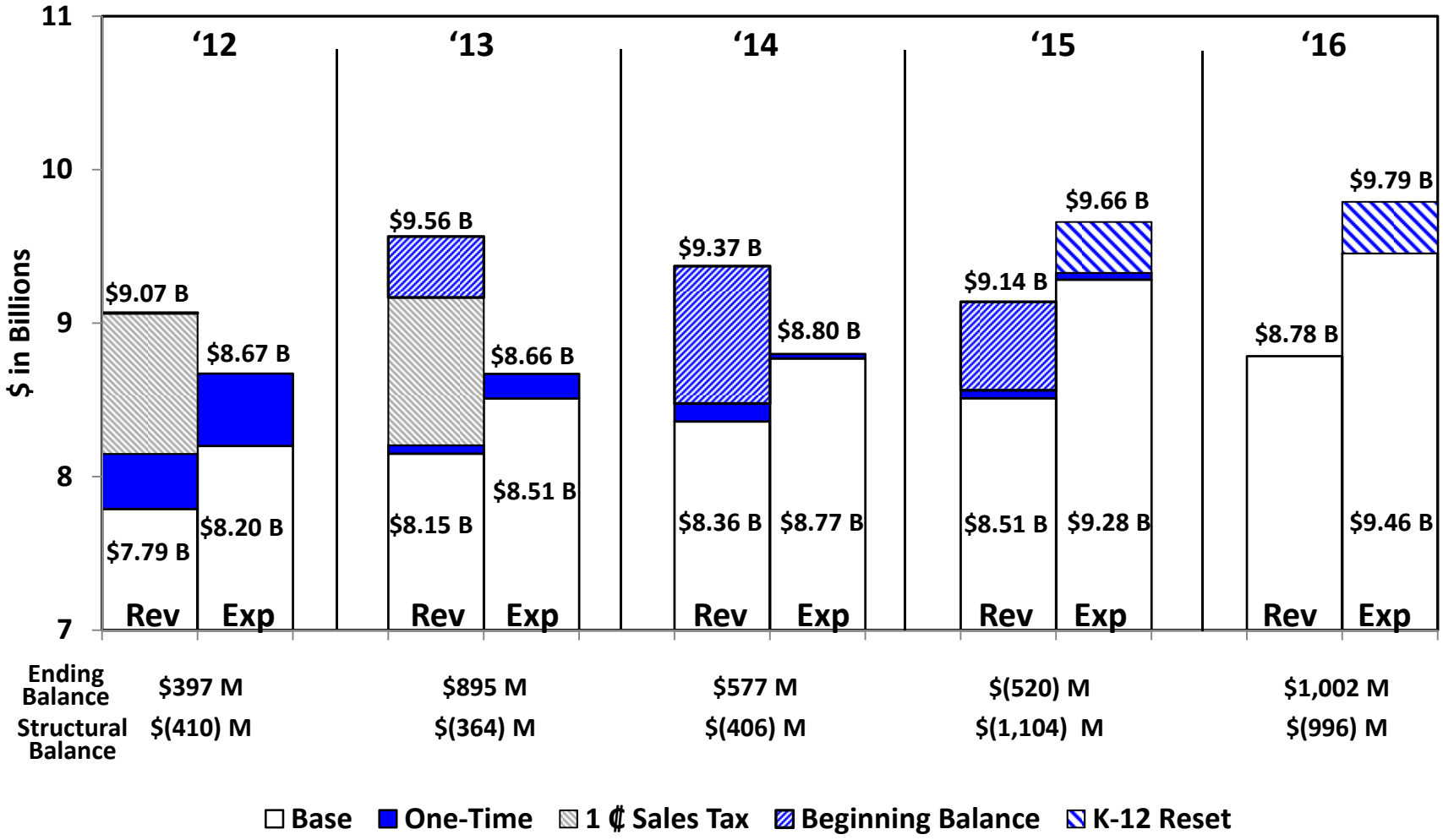
The Structural Gap Details



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Appendix A: October 2014 4-Sector Forecast

	2015	2016	2017	2018
Sales Tax				
JLBC Forecast	4.1%	4.5%	4.8%	5.0%
UA – Low	2.8%	3.1%	5.2%	6.2%
UA – Base	5.0%	6.1%	7.3%	7.2%
FAC	4.1%	4.1%	4.9%	4.7%
Average:	**4.0%**	**4.5%**	**5.6%**	**5.8%**
Individual Income Tax				
JLBC Forecast	4.5%	5.4%	5.0%	5.0%
UA – Low	1.2%	2.9%	4.9%	6.2%
UA – Base	3.7%	5.6%	6.3%	7.0%
FAC	3.4%	4.5%	4.6%	4.6%
Average:	**3.2%**	**4.6%**	**5.2%**	**5.7%**
Corporate Income Tax				
JLBC Forecast	(3.3)%	1.0%	3.5%	4.5%
UA – Low	(1.0)%	(0.2)%	(6.3)%	(10.2)%
UA – Base	1.6%	6.0%	0.1%	(7.4)%
FAC	(10.3)%	(5.9)%	6.3%	6.5%
Average:	**(3.2)%**	**0.4%**	**0.6%**	**(2.0)%**
JLBC Weighted Average	**3.7%**	**4.7%**	**4.8%**	**5.0%**
UA Low Weighted Average	**1.8%**	**2.8%**	**4.5%**	**5.7%**
UA Base Weighted Average	**4.2%**	**5.9%**	**6.5%**	**6.5%**
FAC Consensus Weighted Average	**2.8%**	**3.7%**	**4.8%**	**4.7%**
"Big-3" Weighted Average	**3.1%**	**4.3%**	**5.2%**	**5.4%**
Consensus Weighted Average*	**3.4%**	**4.1%**	**5.1%**	**5.2%**
Adjusted Consensus Weighted Average**	**2.2%**	**3.0%**	**4.4%**	**4.6%**

* Adjusted for small revenue categories

** Adjusted for tax law changes

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