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# **FY 2016 JLBC Baseline**

**Full Version**

**January 16, 2015**

**JLBC**

# Summary of Current Budget Status

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- ❑ The Baseline compares the 4-sector consensus revenue forecast with cost of current funding formulas through '18
- ❑ Prior to the K-12 litigation, the current year (FY '15) baseline shortfall is \$(148) M, followed by \$(678) M in '16
- ❑ The K-12 inflation “reset” ruling would increase the shortfall to \$(480) M in '15 and \$(1.02) B in '16
- ❑ The cash balance estimates exclude the \$464 M available in the Budget Stabilization Fund

# Restatement of Potential Ending Balances

- Does Not Reflect Impact if Litigation Back Payments Are Awarded

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	\$ in M	
<u>After:</u>	<u>FY '15</u>	<u>FY '16</u>
• January FAC	\$(148)	\$ (678)
• January FAC + K-12 Reset	(480)	(1,015)

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

# Forecast Risks

- 1% Variance Yields \$575 M Over 3 Years

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## Potential Gains

- National economic recovery may provide upside gain, in part, by generating more in-state migration
- Gas price windfall will also help stimulate retail sales, but is likely temporary

## Potential Losses

- Uncertainty of international events
- Litigation – prison health, retirement, hospital assessment

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# Revenue Overview

# '15 Improved Over Slow '14 Due to Corporate Collections

## - Otherwise Weak Growth

	<u>'14 Budgeted</u>	<u>'14 Actual</u>	<u>'15 1<sup>st</sup> Half</u>
Sales	5.7%	5.5%	3.4%
Individual Income	3.7%	1.9%	3.2%
Corporate Income	(3.5)%	(13.1)%	21.4%
Overall	3.9%	2.7%	4.6%

- ❑ Without corporate income tax collections, year-to-date overall increase would be 3.6%
- ❑ December is first month that revenues have been above forecast since March 2014
- ❑ Through December, year-to-date revenues \$(60) M below forecast

# AZ Economy is Growing, But Slower than Average

## - Given Our Size, Historical Norm May Not be Realistic

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### Main Factors Behind Slow Growth

	<u>Historical</u>	<u>Current</u>
Overall Job Growth	3.9%	2.6%
Construction Employment	5.7%	(3.5)%
Population Growth	3.1%	1.5%
Building Permits	38K	17K

### Other Factors

- Great Recession “hangover” may be hampering investment
- Tougher loan standards and declining household formation have hurt housing demand
- Flat wages have limited consumer purchases
- Reduced Federal defense contracts in Arizona

# 4-Sector Forecast Has Slow Growth Until '18

## Components of 4-Sector

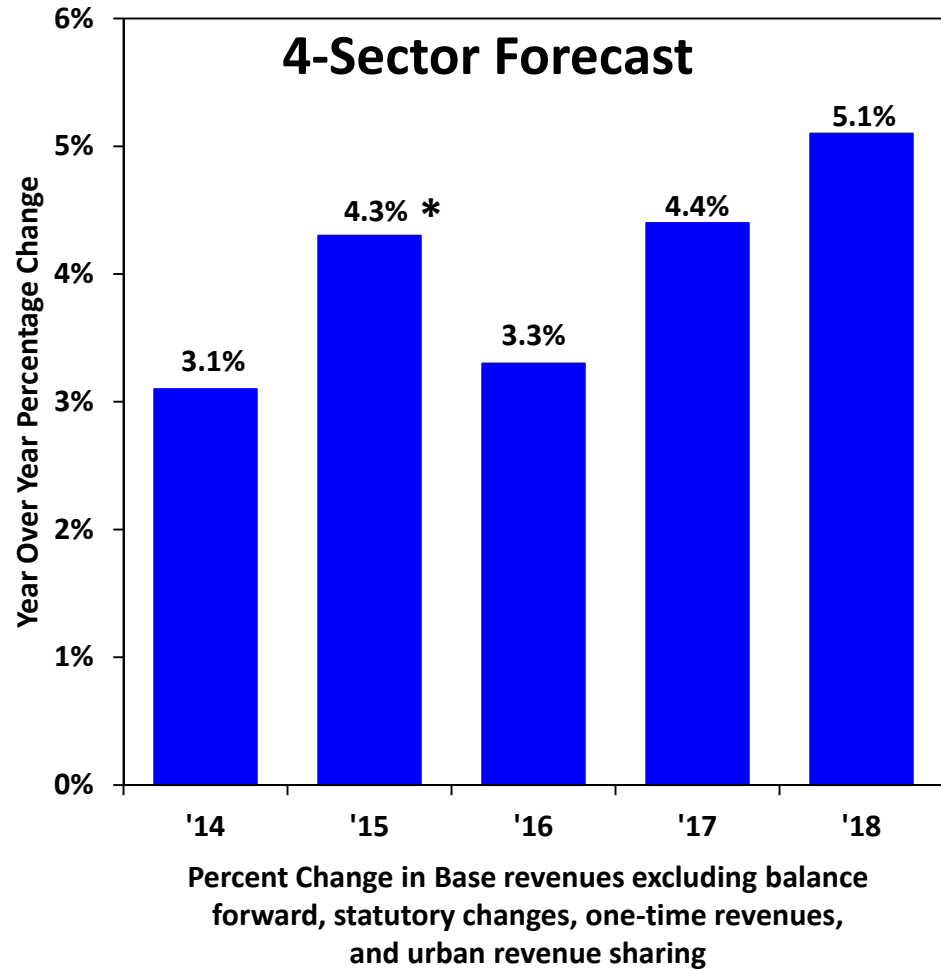
- ☐ Finance Advisory Committee
- ☐ UA base model
- ☐ UA lower model
- ☐ JLBC Staff

## Chance of Exceeding Forecast

- ☐ 60%

## Long Run Average Growth

- ☐ 4.75%

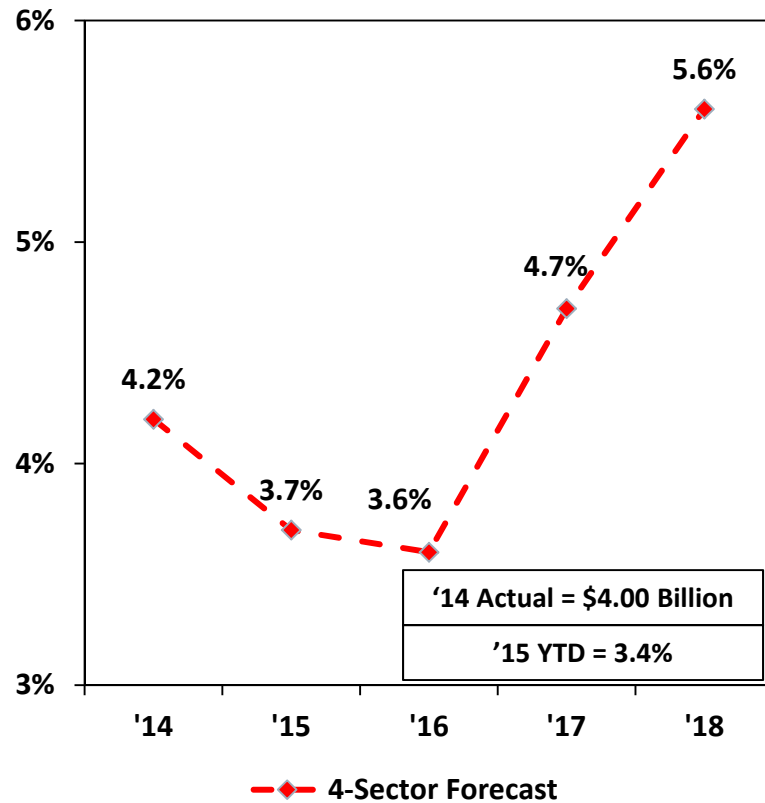


\* Adjusted for corporate YTD collections



# Sales Tax

- Projected Growth of 3.7% in '15 and 3.6% in '16



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

- ❑ Retail sector of sales up 7.8% in '14; 4.5% so far in '15
- ❑ Contracting up 11.2% in '14; near flat in '15 YTD
- ❑ Overall, 3.4% growth through first half of fiscal year
- ❑ Will Jan '15 contracting law have an impact?
- ❑ How much will drop in gas prices spur taxable sales?

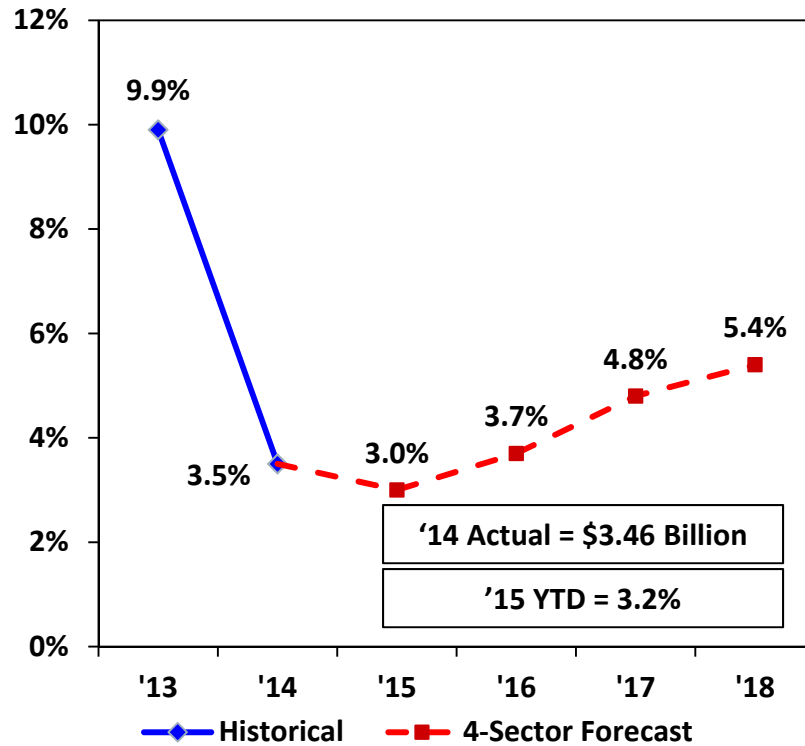
# Potential 1-Time Windfall from Gas Prices

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- ❑ Dramatic decline in gas prices will increase disposable income
- ❑ General Fund revenue impact will depend on:
  - Duration of oil price decline
  - Propensity to save vs. spend
  - Taxable nature of spending
- ❑ Given uncertainty of all factors, this 1-time windfall could be between \$10M -\$40M
- ❑ Potential gain not reflected in 4-sector forecast

# Individual Income Tax

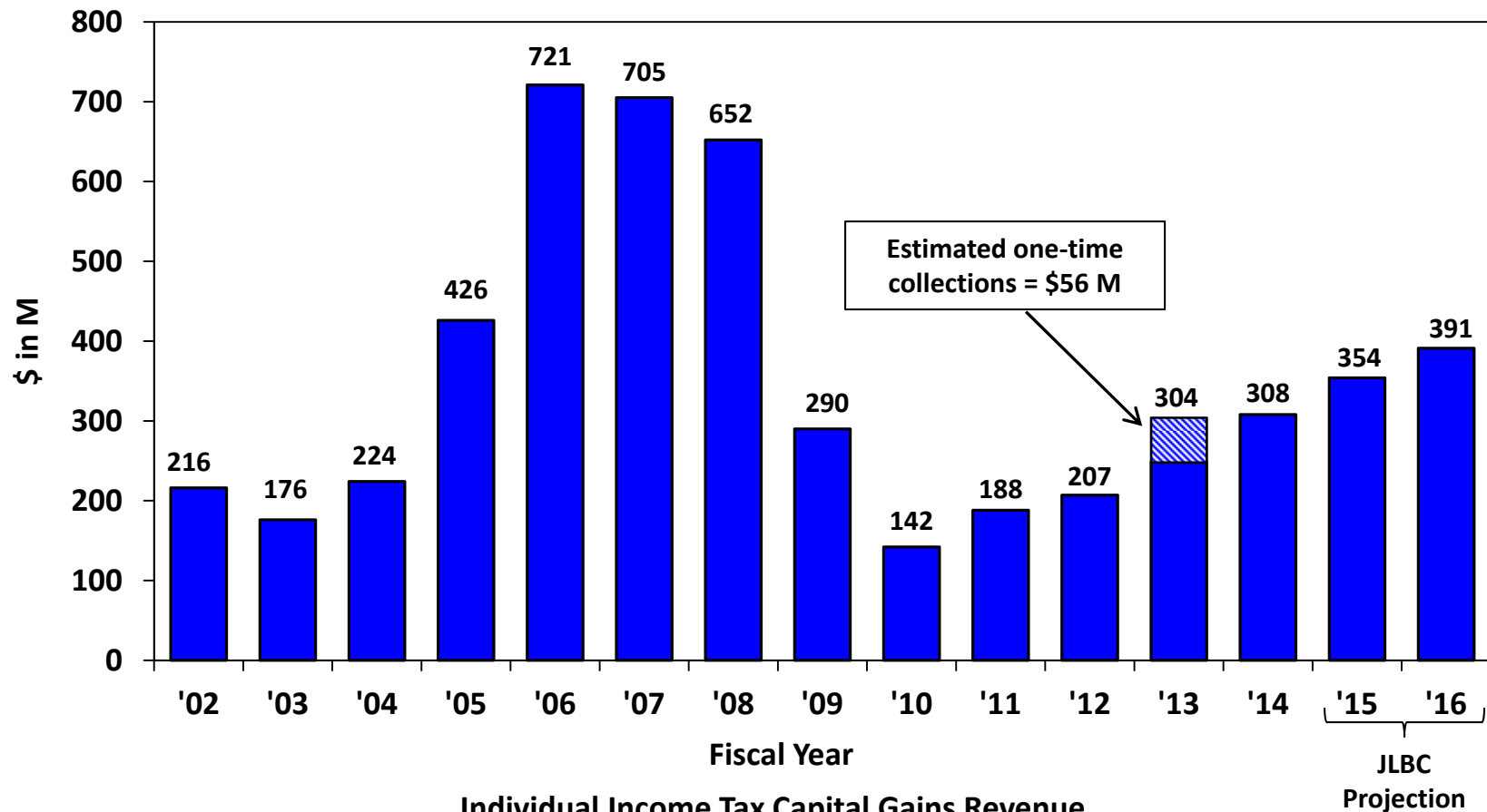
- Projected Growth of 3.0% in '15 and 3.7% in '16



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 3.4% withholding gain in ‘14
- ❑ 1<sup>st</sup> half ‘15 withholding growth was 2.8%
- ❑ Projected 15% capital gains growth; April filing will verify

# Volatility of Capital Gains Complicate Forecasting

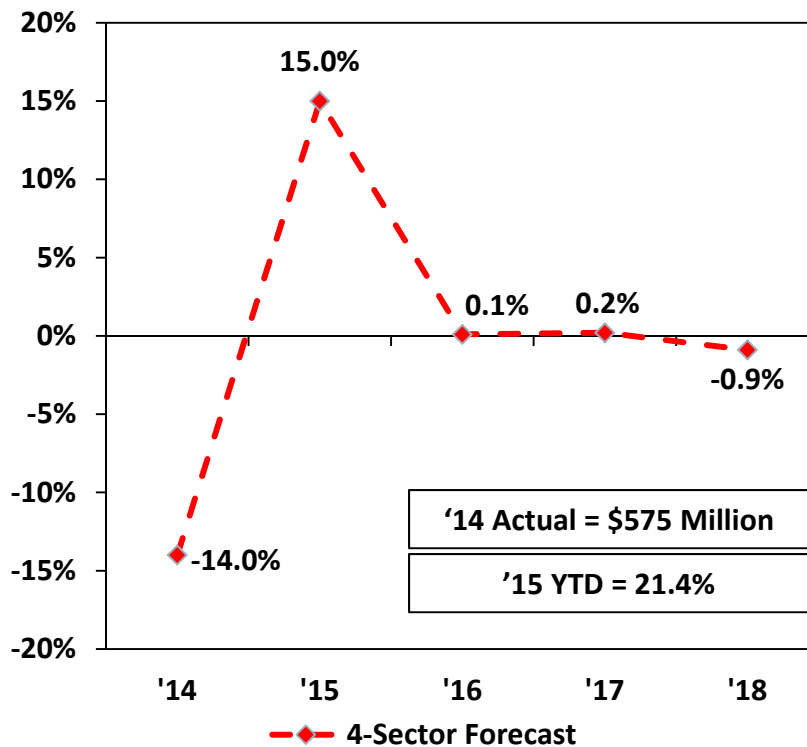


Individual Income Tax Capital Gains Revenue  
 '14 through '16 Not Adjusted for Tax Law Changes



# Corporate Income Tax

- Projected Growth of 15.0% in '15 and 0.1% in '16

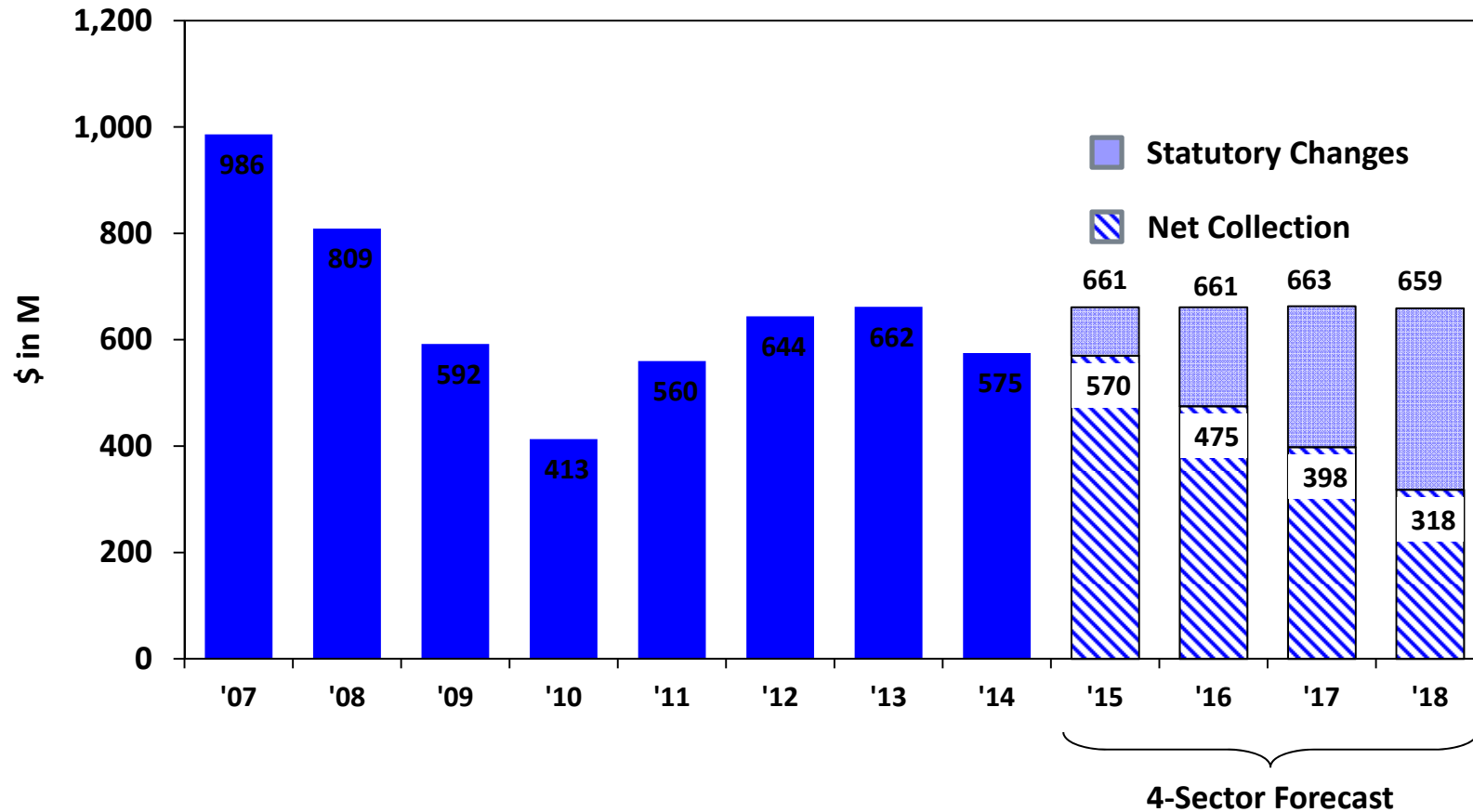


Percent Change in Base Revenue Excluding  
Statutory Changes and One-Time Changes

- ❑ After '14 decline, '15 YTD growth is 21.4%
- ❑ 4-sector '15 growth is 3.7% - would require (10)% 2<sup>nd</sup> half decline
- ❑ '15 adjusted to 15% annual growth – 10% 2<sup>nd</sup> half growth
- ❑ Filing extension may delay the impact of rate cuts

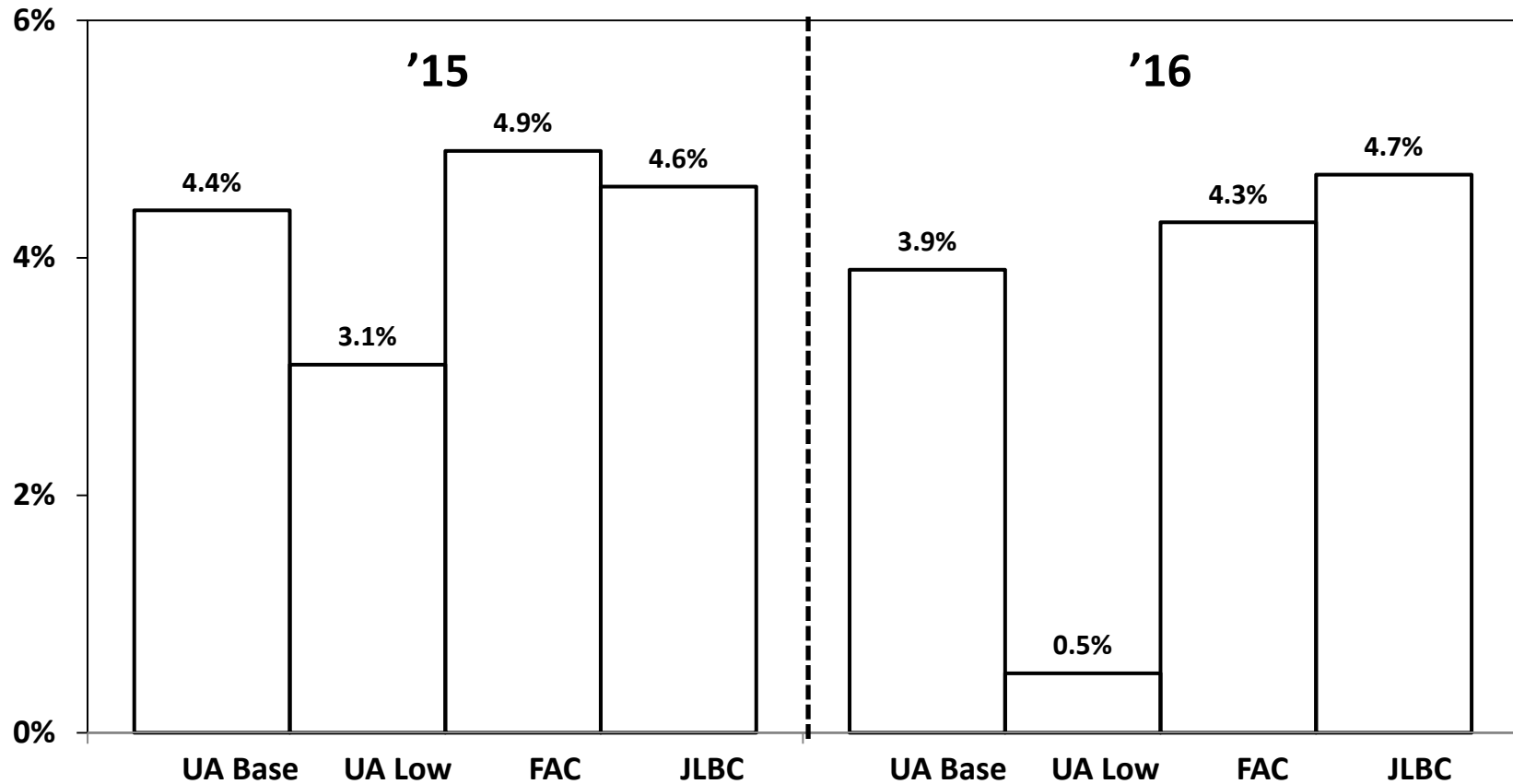
# '18 CIT Projected to be \$318 M

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



# Consensus Growth Rate is 4.3% in '15 and 3.3% in '16

- Prior to Corporate Adjustment, '15 Growth More Comparable to '16 <sup>1/</sup>



Details in Appendix A

1/ Prior to adjustment for corporate collections, the '15 growth rate is 3.6%



# Phase-In of \$267 M of Enacted Tax Reductions

	\$ in M		
	<u>'16</u>	<u>'17</u>	<u>'18</u>
<input type="checkbox"/> Corporate Rate Reduction/Sales Factor	(68)	(61)	(60)
<input type="checkbox"/> 25% Capital Gains Reduction	(11)	0	0
<input type="checkbox"/> 1-time Income Tax Indexing	(6)	6	0
<input type="checkbox"/> Corporate School Tuition Indexing	(9)	(10)	(12)
<input type="checkbox"/> Other	(18)	(13)	(5)
<b>Total</b>	<b><u>(112)</u></b>	<b><u>(78)</u></b>	<b><u>(77)</u></b>

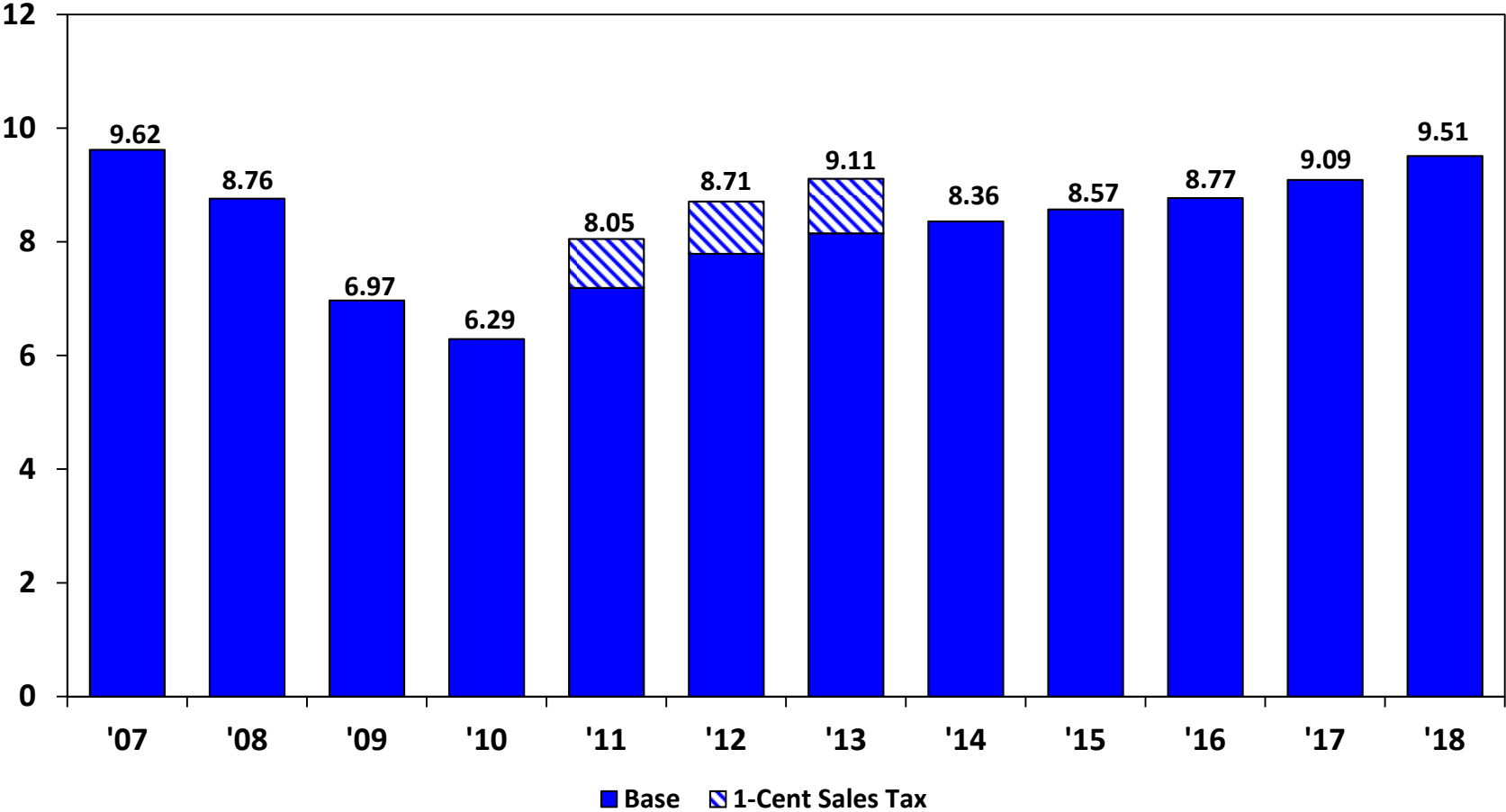
By '18, revenue base is forecast to be a total of \$267 M lower than if no enacted changes



# Tax Law Phase-In Reduces '16 Growth Rate to 1.6%

	\$ in M Above Prior Year		
	<u>'16</u>	<u>'17</u>	<u>'18</u>
Base Revenue Growth (3.3%/4.4%/5.1%)	300	413	495
Elimination of Fund Transfers	(54)	--	--
Previously Enacted Tax Legislation	(112)	(78)	(77)
Urban Revenue Sharing	<u>3</u>	<u>(10)</u>	<u>(5)</u>
<b>Total</b>	<b>137</b>	<b>325</b>	<b>413</b>
<b>% Change</b>	<b>1.6 %</b>	<b>3.7%</b>	<b>4.5%</b>

# The Last Decade of General Fund Revenues



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



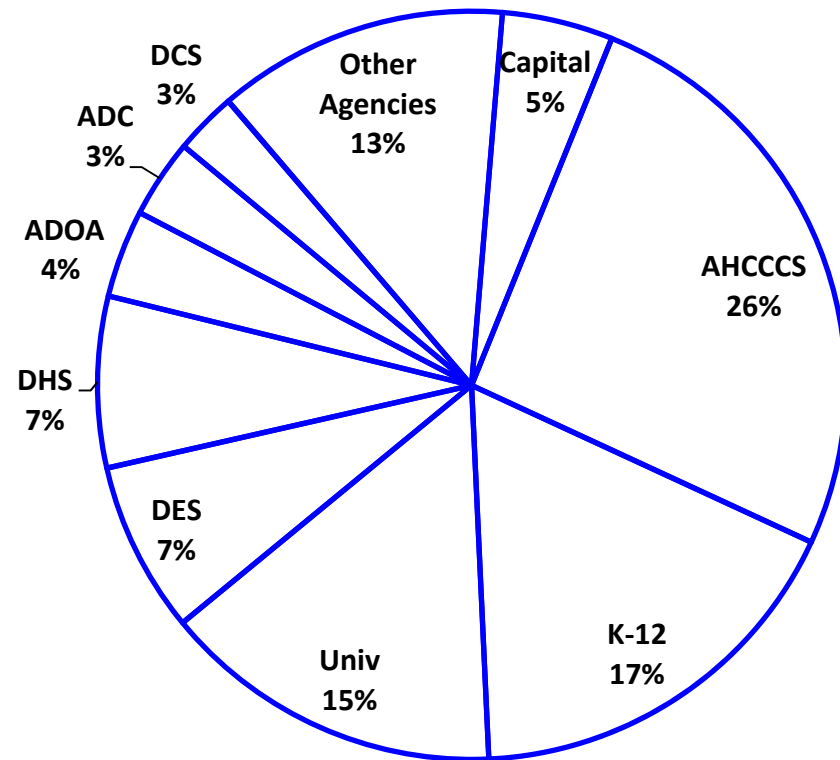
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# Spending Overview

# FY 2015 Total Spending is \$32 Billion

## - General and Non-General Fund

<u>Budget Unit</u>	<u>\$ in Millions</u>
AHCCCS	\$ 8,188.9
Education (K-12)	5,516.8
Universities	4,708.6
Economic Security	2,365.9
Health Services	2,345.5
Administration	1,192.7
Corrections	1,095.4
Child Safety	873.9
Other Agencies	3,988.0
Capital	1,515.7
<b>TOTAL</b>	<b><u><u>\$ 31,791.4</u></u></b>



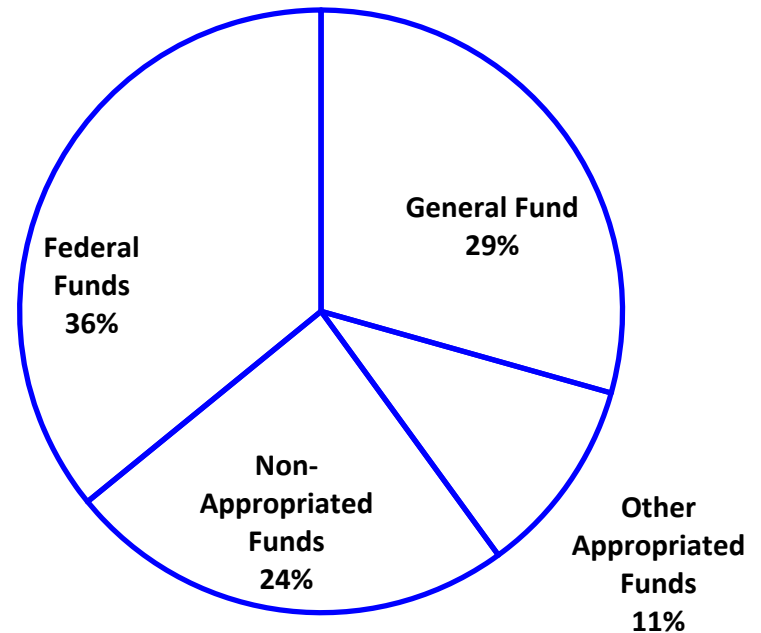
# The \$9.3 B General Fund Share is 29% of Total Funds

## - GF Share Down from 43% in FY '02

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**FY '15 Enacted**

	<b><u>\$ in Millions</u></b>
General Fund	\$ 9,336.0
Other Appropriated Funds	3,377.1
Non-Appropriated Funds	7,671.8
Federal Funds	<u>11,406.5</u>
<b>TOTAL</b>	<b><u><u>\$ 31,791.4</u></u></b>

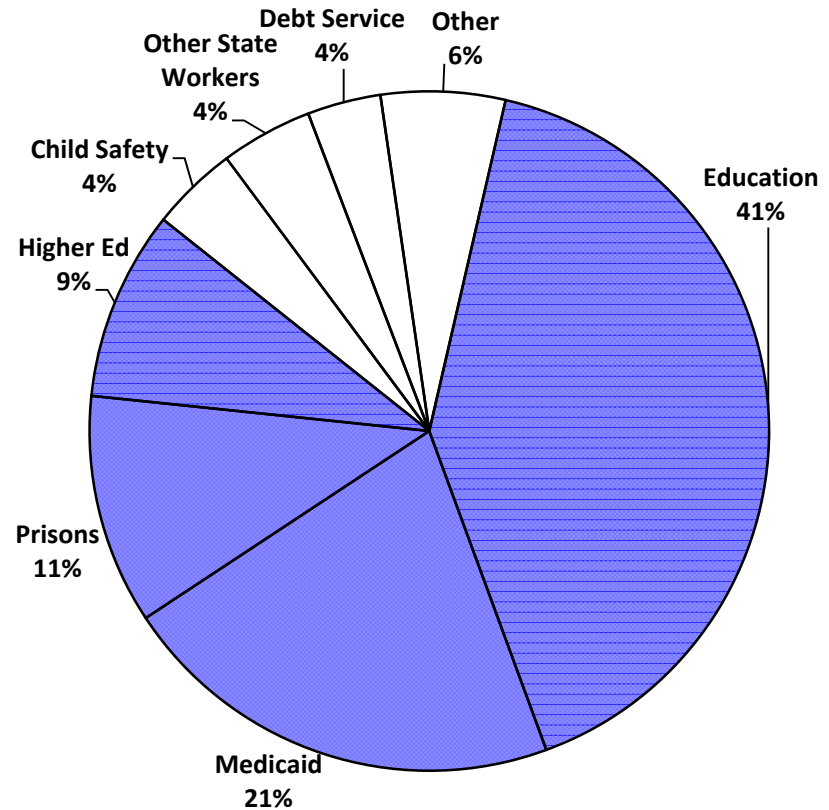


# The 3 Main Drivers of General Fund Spending: Education, Health, and Prisons

- Represents 82% of '15 On-Going General Fund Budget



	<u>\$ in Millions</u>
K-12 Education	\$ 3,808.4
Medicaid	1,989.8
Prisons	1,021.2
Higher Education	843.3
Other State Workers	408.6
Child Safety	386.0
Debt Service	326.7
Other	552.0
<b>TOTAL</b>	<b><u><u>\$ 9,336.0</u></u></b>



# Updated '16 – '18 Spending Projections

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- ❑ Baseline reflects cost of active statutory funding formulas
- ❑ Continues annual suspension of \$375 M of inactive formulas - mostly ADE funding
- ❑ Continues \$1.2 B in “rollover” payments
- ❑ Assumes no discretionary spending increases over 3 years – highly unlikely based on past practice

# Projected Baseline Spending Changes

	\$ in M Above Prior Year		
	'16	'17	'18
K-12 Formula	181	210	164
Medicaid Formula	29	121	137
DCS 1-Time Backlog	(16)	(8)	0
ADC Operating	8	0	0
Capital	(42)	0	0
HURF Shift (\$30 M to \$60 M)	0	30	0
One-Time/Other	(70)	(16)	2
<b>Additional Spending</b>	<b>90</b>	<b>337</b>	<b>303</b>
<b>Total Spending</b>	<b>\$9,447</b>	<b>\$9,784</b>	<b>\$10,087</b>
<b>% Growth</b>	<b>1.0%</b>	<b>3.6%</b>	<b>3.1%</b>
<b>K-12 Inflation Reset</b>	<b>\$337</b>	<b>\$341</b>	<b>\$346</b>
<b>Revised Total</b>	<b>\$9,784</b>	<b>\$10,125</b>	<b>\$10,433</b>



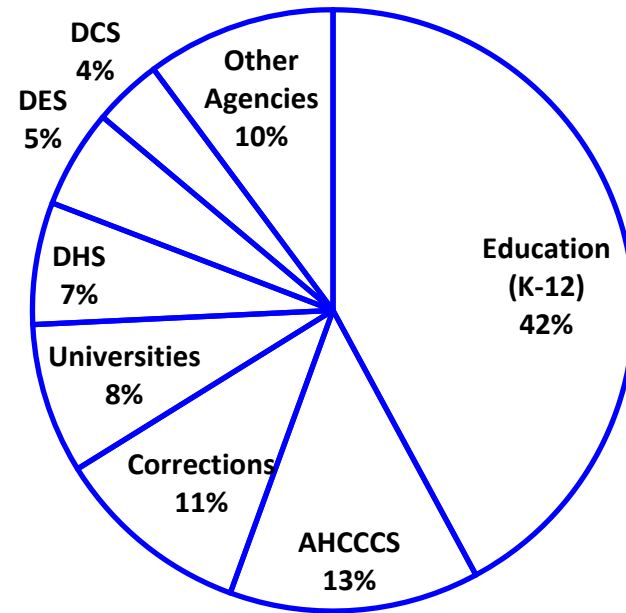
# Main Caseload Assumptions

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- ❑ Before “reset”, K-12 would grow by \$181 M
  - 1.6% inflation/1.4% student growth/property tax cut
- ❑ Medicaid ‘16 spending grows 1.2%
  - 2.0% caseload, 3.0% capitation, and better federal match rates
- ❑ DCS funding adjusted consistent with May 2014 plan
- ❑ ADC reflects annualized cost for opening 1,000 new beds

# FY '16 General Fund Baseline by Agency

<u>Budget Unit</u>	<u>\$ in Millions</u>
Education (K-12)	\$ 3,989.6
AHCCCS	1,272.3
Corrections	1,004.4
Universities	765.9
Health Services	622.3
Economic Security	501.6
Child Safety	351.1
Other Agencies	964.4
<b>Total Operating Budget</b>	<b><u><u>\$ 9,471.6</u></u></b>



\*Litigation inflation reset would add \$337 M

# K-12 Baseline Spending Change

	GF \$ in M Above Prior Year		
	'16	'17	'18
'15 Shortfall	24	0	0
Student Growth (1.4% for all years)	82	83	84
Higher Average Cost Per Pupil	23	23	23
Charter Conversions	(25)	0	0
Full Inflation (1.6%, 1.9%, 1.8%)	87	103	101
Property Taxes from New Construction	(37)	(44)	(44)
Property Tax Assessment Ratio Reduction	26	45	0
Other	1	0	0
<b>Total Additional Spending*</b>	<b>181</b>	<b>210</b>	<b>164</b>
<b>% Growth</b>	<b>4.8%</b>	<b>5.3%</b>	<b>3.9%</b>

\*Litigation inflation reset would add \$337 M in '16, \$341 M in '17, and \$346 M in '18

# Status of K-12 Inflation Litigation

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- ❑ 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

# What Is Potential Cost of K-12 Litigation?

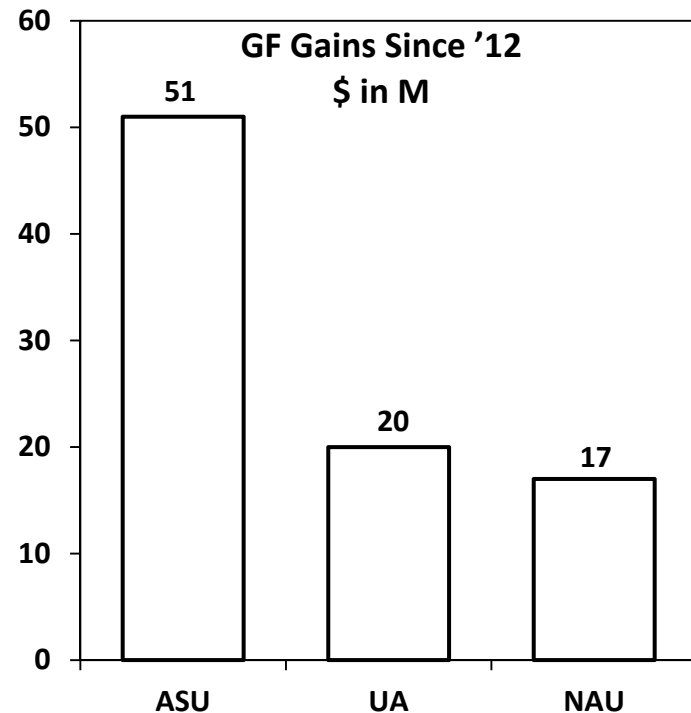
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- ❑ Superior Court concurred with plaintiffs' request to reset the formula for foregone inflation
  - "Reset" would cost \$337 M in '16
- ❑ The Superior Court is now considering back payments
  - Back payments could cost \$250 M annually for 5 years
- ❑ Resolution could take a year – depends on appeals

# University Restoration by Campus

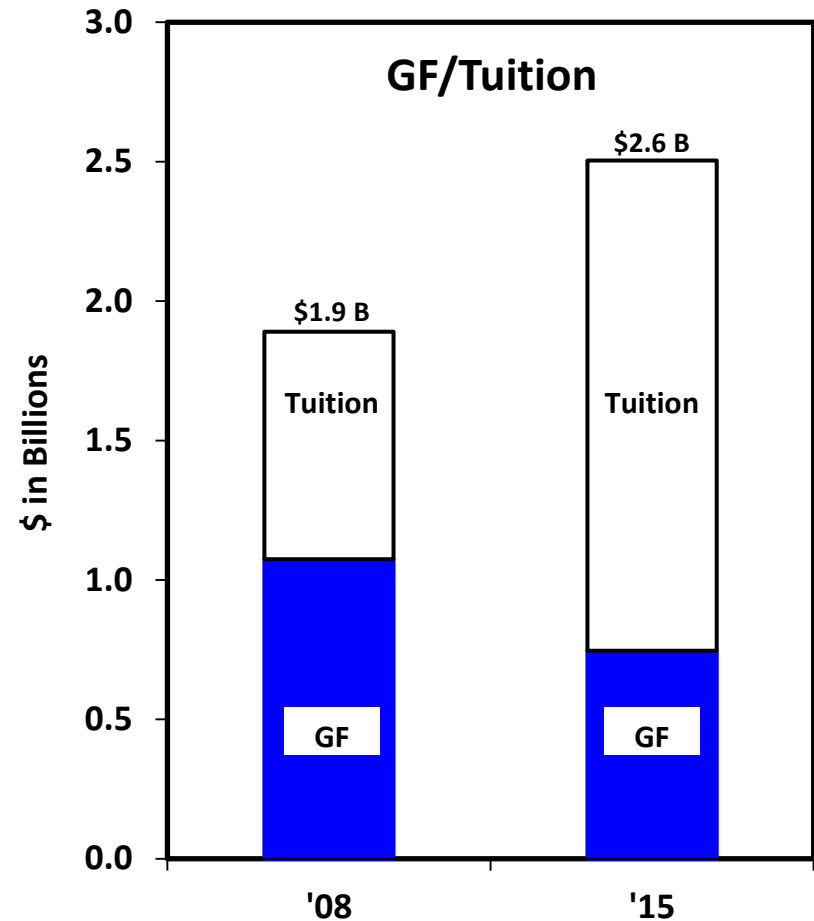
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- ❑ University GF reduced by \$435 M through '12; \$88 M restored
- ❑ ASU/NAU gain due to parity
- ❑ UA due to student population increase at Phoenix Biomedical
- ❑ Only minor '16 Baseline adjustments



# University GF Reduction Since '08 Offset by Tuition Increases

- Avg '08-'15 tuition grew from \$4.8 K to \$10.4 K
- Total tuition increased from \$816 M to \$1.8 B
- Total GF + Tuition grew from \$1.9 B to \$2.6 B
- '08-'15 GF/Tuition per student \$ grew from \$17.0 K to \$17.7 K



# Medicaid Agencies Baseline Spending Changes

	GF \$ in M Above Prior Year		
	'16	'17	'18
AHCCCS	(2)	67	75
DHS	9	26	31
DES	22	28	31
<b>Total</b>	<b>29</b>	<b>121</b>	<b>137</b>
<b>% Growth</b>	<b>1.2%</b>	<b>5.1%</b>	<b>5.4%</b>

- ❑ Savings from increasing the federal match rate from 68.2% to 68.8%
- ❑ 3% cap rate adjustment
- ❑ AHCCCS/DHS Base enrollment growth of 2% ; DD growth of 4.5%



# AHCCCS Caseloads

-Enrollment Increased By 337 K to 1.6 M in CY '14

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<u>Population</u>	Enrollment (Thousands)		
	December <u>2013</u>	January <u>2015</u>	<u>Change</u>
Traditional	880	962	82
Childless Adults	68	279	211
Adult Expansion	-	36	36
All Others	<u>310</u>	<u>317</u>	<u>7</u>
<b>TOTAL</b>	<b>1,258</b>	<b>1,594</b>	<b>337</b>

# DCS Baseline Spending Estimates

	GF in \$ in M Above Prior Year		
	'16	'17	'18
One-Time Backlog	(11)	(12)	0
Preventive Services	4	4	0
Automation Replacement	(5)	5	0
Other	(4)	0	0
<b>Total Additional Spending</b>	<b>(16)</b>	<b>(3)</b>	<b>0</b>

- '16 & '17 estimates consistent with May Special Session plan
- Automation Replacement funding deferred to '17, consistent with procurement timetable
- Baseline also deletes \$25 M in one-time transition funding to ADOA

# Department of Corrections Baseline Spending Changes

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GF \$ in M Above Prior Year

	<u>'16</u>
Annualize 500 Medium Security Beds	7.3
Annualize 500 Maximum Security Beds	<u>0.3</u>
<b>Total</b>	7.6

- Annualizes 500 private beds opened in '15
- Annualizes 500 maximum security public beds that just opened
- Excludes cost related to settlement of inmate health care litigation – may add up to \$25 M
- Excludes cost of employee retirement rate increase - \$2 M or \$15 M depending on phase in

# ADC Bed Surplus/Shortfall

## - Possible Total Bed Shortfall in '16




June 2016 Total Male Bed (Shortfall)/Surplus		
<u>Classification</u>		
<u>Level</u>	<u>June 15</u>	<u>June 16</u>
Minimum	82	(136)
Medium	(5)	(559)
Close	(42)	(59)
Maximum	528	477
<b>Total</b>	<b>563</b>	<b>(277)</b>

- Prison population projected to grow by 840 male inmates in '16
- Includes more than 5,400 temporary beds

# General Fund Debt Service Cost \$364 M

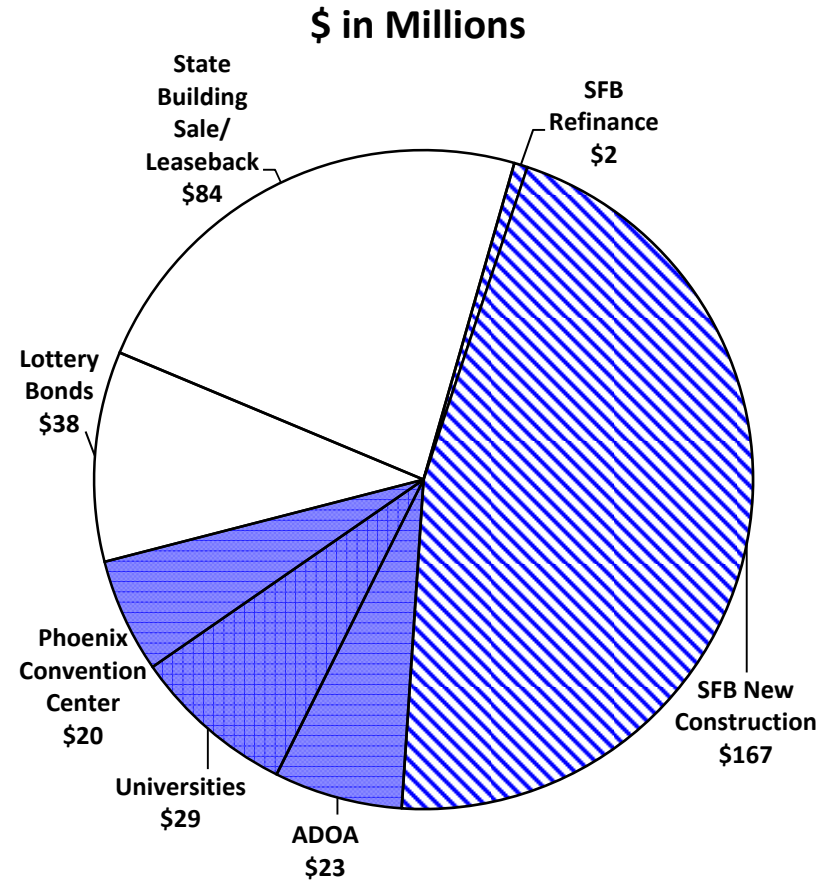
- Represents 7<sup>th</sup> Largest Budget Unit

## Annual Payments

	Capital Facilities/Uses	\$ 72 M
	School Facilities Board	\$ 169 M
	Operating	\$ 123 M

## '16 Baseline Spending Change

- Only minor adjustments



'15 General Fund = \$364 M

Includes \$38 M Lottery Bonds

# State Employer Retirement Impacts

- '15 General Fund Cost is \$166 M; Total State = \$458 M

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- ❑ ASRS employer rate will decrease from 11.60% in '15 to 11.47% in '16
- ❑ AZ Supreme Court Ruling on permanent benefit increases raises employer rate in other systems
- ❑ Baseline excludes cost of rate increase, which depends on whether higher rate is phased in

	'16 GF \$ in M Above '15	
	<u>Phase In</u>	<u>Full Rate</u>
PSPRS	\$ 0.9	\$ 4.4
CORP	2.1	15.7
EORP	0	1.4*
<b>GF Total Increase</b>	<b>\$ 3.0</b>	<b>\$ 21.5</b>

\*If fixed rate changed

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# Projected Ending Balance Estimates

# Updated '15 – '18 Ending Balance Projections

- January FAC Revenue With Projected Spending

<b>Baseline</b>	'15	'16	'17	'18
Balance Forward	\$577 M	--	--	--
Revenues	\$8.63 B	\$8.77 B	\$9.09 B	\$9.51 B
Spending	\$9.36 B	\$9.45 B	\$9.78 B	\$10.09 B
<b>Ending Balance</b>	<b><i>\$(148) M</i></b>	<b><i>\$(678) M</i></b>	<b><i>\$(690) M</i></b>	<b><i>\$(581) M</i></b>
K-12 Reset	\$332 M	\$337 M	\$341 M	\$346 M
<b>Revised Balance</b>	<b><i>\$(480) M</i></b>	<b><i>\$(1.02) B</i></b>	<b><i>\$(1.03) B</i></b>	<b><i>\$(928) M</i></b>

Does not include \$464 M Rainy Day Fund

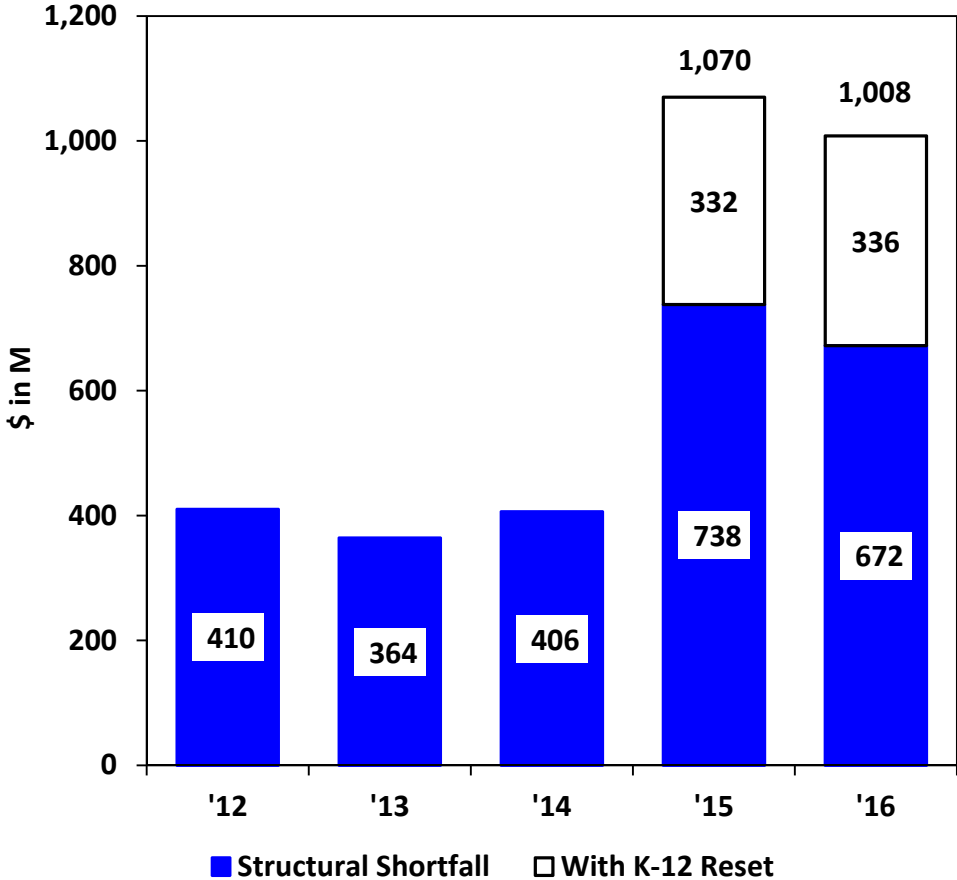


# The Path from a \$900 M Surplus to a Large Shortfall

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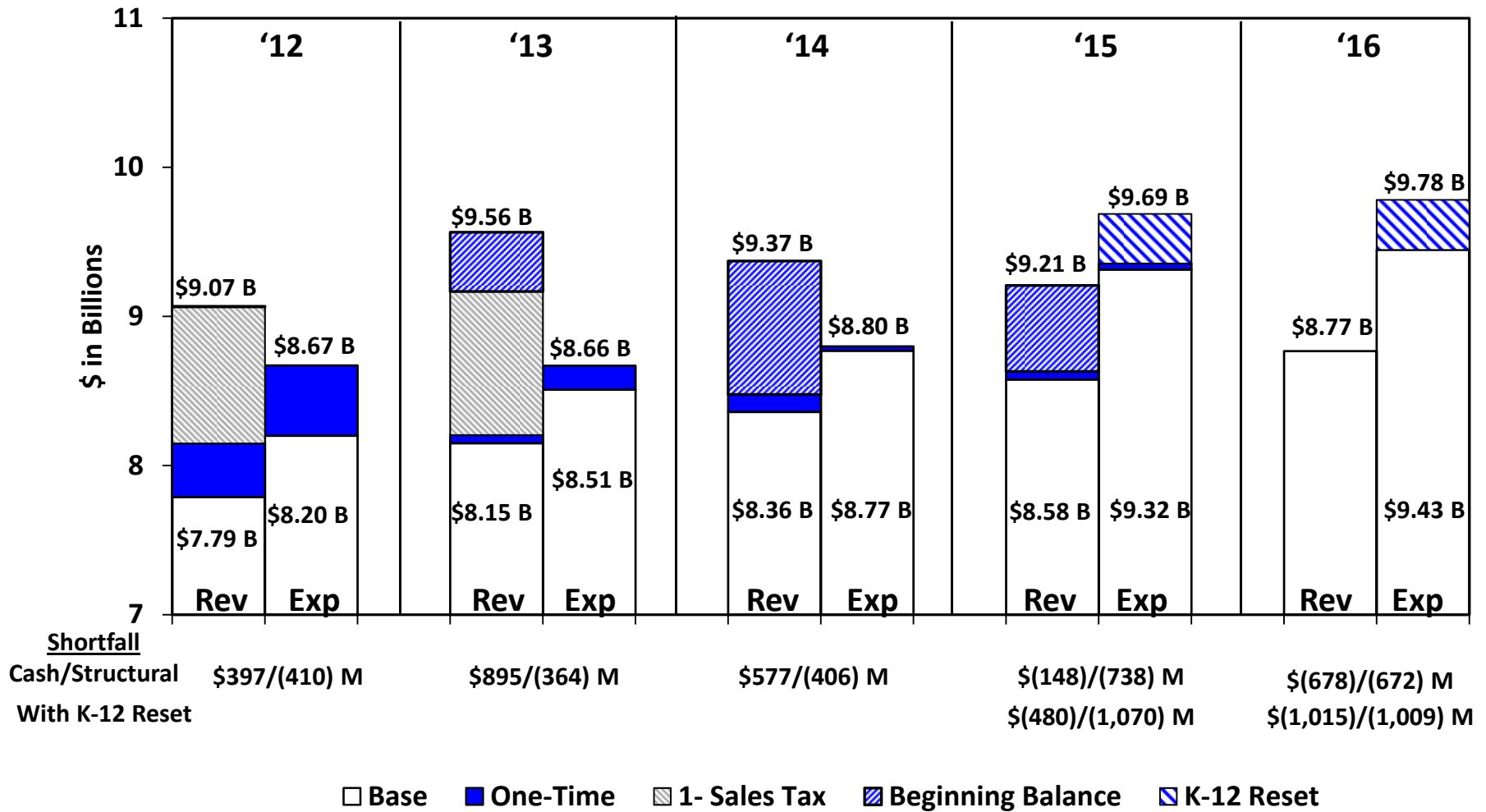
- ❑ Current shortfall is not unexpected -- '15 budget projected shortfalls of \$(237) M in '16 and \$(490) M in '17
- ❑ The state had an underlying structural shortfall in past several years
- ❑ When the \$900 M 1-cent sales tax ended in '13, we replaced it with a \$900 M 1-time carryforward in '14
- ❑ Lower than expected revenue growth
- ❑ Phase-in of tax law changes enacted in '11 and '12
- ❑ K-12 inflation litigation

# The Ongoing Structural Shortfall Part of Current Problem



- Structural balance compares ongoing revenue and spending
- 1-cent sales tax and carryforward kept '12-'14 balanced

# The Structural Gap Details



# Suggestions to Improve Fiscal Policy

- Currently 4<sup>th</sup> Worst Credit Rating Among States

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- ❑ Align ongoing revenues and spending – develop multi-year targets
- ❑ Reduce reliance on 1-time solutions over time
- ❑ Set aside 1-time revenues into a separate fund
  - Excess ending balances
  - Excess capital gains
  - Windfalls (retail gain with gas price plunge)
- ❑ Dedicate 1-time \$ for 1-time purposes
  - Rebates/Operating debt buyback/Infrastructure/IT Modernization

# California Initiative Addresses Volatility

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- Voter approved in November 2014
- 1.5% of annual General Fund revenue will be deposited into Rainy Day Fund
- Excess capital gains income tax collections will be deposited into the fund as well
- 50% of fund will be used to buy down state debts, including unfunded retirement and operating loans
- Rainy Day Fund capped at 10% of GF revenue; excess dedicated to infrastructure
- Emergency provisions allow deposit requirements to be suspended

# Other Suggested Fiscal Policy Improvements

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- ❑ Enhance current tax analysis and administration
  - Increase timeliness of tax credit reporting
  - Would improve our understanding of revenue changes
- ❑ Increase transparency of retirement expenses which are not delineated separately in budget
  - JLBC Baseline Book begins this process
- ❑ Evaluate accountability measures as we consider consolidating acute and behavioral health services
  - Retain ability to measure behavioral health effort in light of Arnold litigation settlement

# Appendix A: January 2015 4-Sector Forecast

	<u>2015</u>	<u>2016</u>	<u>2017</u>	<u>2018</u>
<b>Sales Tax</b>				
JLBC Forecast	4.0%	4.4%	4.8%	5.0%
UA – Low	2.5%	1.1%	3.3%	5.4%
UA – Base	4.0%	4.4%	5.8%	6.6%
FAC	4.5%	4.4%	5.0%	5.2%
Average:	<b>3.7%</b>	<b>3.6%</b>	<b>4.7%</b>	<b>5.6%</b>
<b>Individual Income Tax</b>				
JLBC Forecast	3.6%	5.4%	5.9%	5.9%
UA – Low	1.8%	1.0%	3.0%	4.7%
UA – Base	3.0%	3.8%	5.0%	6.0%
FAC	3.7%	4.4%	5.0%	5.1%
Average:	<b>3.0%</b>	<b>3.7%</b>	<b>4.8%</b>	<b>5.4%</b>
<b>Corporate Income Tax</b>				
JLBC Forecast	15.0%	3.1%	3.5%	4.5%
UA – Low	(2.0)%	(6.6)%	(8.8)%	(11.7)%
UA – Base	(1.2)%	0.7%	(0.2)%	(7.2)%
FAC	2.9%	3.1%	5.1%	7.3%
Average:	<b>3.7%</b>	<b>0.1%</b>	<b>0.2%</b>	<b>(0.9)%</b>
JLBC Weighted Average	<b>4.6%</b>	<b>4.7%</b>	<b>5.2%</b>	<b>5.4%</b>
UA Low Weighted Average	<b>1.9%</b>	<b>0.5%</b>	<b>2.5%</b>	<b>4.4%</b>
UA Base Weighted Average	<b>3.2%</b>	<b>3.9%</b>	<b>5.1%</b>	<b>5.7%</b>
FAC Consensus Weighted Average	<b>4.0%</b>	<b>4.3%</b>	<b>5.0%</b>	<b>5.3%</b>
“Big-3” Weighted Average*	<b>4.2%</b>	<b>3.4%</b>	<b>4.5%</b>	<b>5.2%</b>
Consensus Weighted Average**	<b>4.3%</b>	<b>3.3%</b>	<b>4.4%</b>	<b>5.1%</b>
Adjusted Consensus Weighted Average***	<b>3.0%</b>	<b>2.1%</b>	<b>3.6%</b>	<b>4.3%</b>
* '15 Adjusted for corporate year-to-date collections				
** Represents on-going revenue adjusted for small revenue categories				
*** Represents on-going revenue adjusted for tax law changes; excludes Urban Revenue Sharing				

**STAFF OF THE  
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- Office Manager ..... Linda Monsanto
- Deputy Directors ..... Steve Schimpp  
..... Stefan Shepherd
- Assistant Director..... Jack Brown
- Principal Economist ..... Tim Everill
- Chief Economist..... Hans Olofsson
- Principal Fiscal Analysts..... Eric Billings  
..... Bob Hull  
..... Andrew Smith  
..... Art Smith
- Senior Fiscal Analysts..... Ben Beutler  
..... Steve Grunig  
..... Jon Stall
- Fiscal Analysts ..... Henry Furtick  
..... Matt Gress  
..... Jeremy Gunderson  
..... Josh Hope  
..... Micaela Larkin  
..... Krista MacGahan  
..... Rebecca Perrera  
..... Tom Ritland
- Administrative Assistant/JLBC & JCCR Clerk ..... Kristy Paddock