
Finance Advisory Committee

Revenue and Budget Update

January 20, 2011

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Summary of the Current Budget Status

Improving, but Long Term Problems Remain

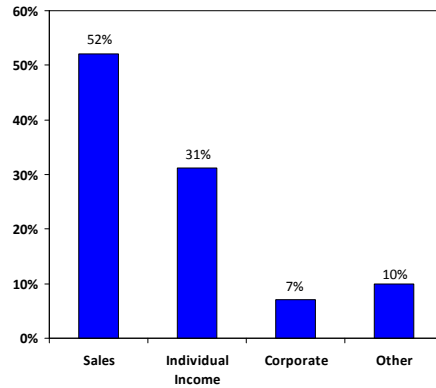
- An improving economy since the summer has increased tax collections and reduced caseload growth in the Medicaid programs.
- Base General Fund Revenue – without the 1¢ tax – is estimated to grow 5.2% in FY '11 and 5.4% in FY '12.
- As a result, the budget shortfall is estimated to be \$(530) million in FY 2011 and \$(975) million in FY 2012.
- While the shortfall estimates have improved, long term problems remain:
 - Lost jobs and foreclosures will delay full recovery
 - The shortfalls do not reflect more than \$1 billion in annually suspended funding formulas still in statute
 - The state will lose nearly \$1 billion in revenue in FY 2014 with the expiration of the 1 cent sales tax.

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FY 2011 General Fund Revenue - 90% Generated by 3 Taxes

Source	(Millions)
Sales and Use Tax	\$ 4,269.6
Individual Income Tax	2,558.9
Corporate Income Tax	573.4
Other	794.6
TOTAL REVENUE	\$ 8,196.5 ^{1/}

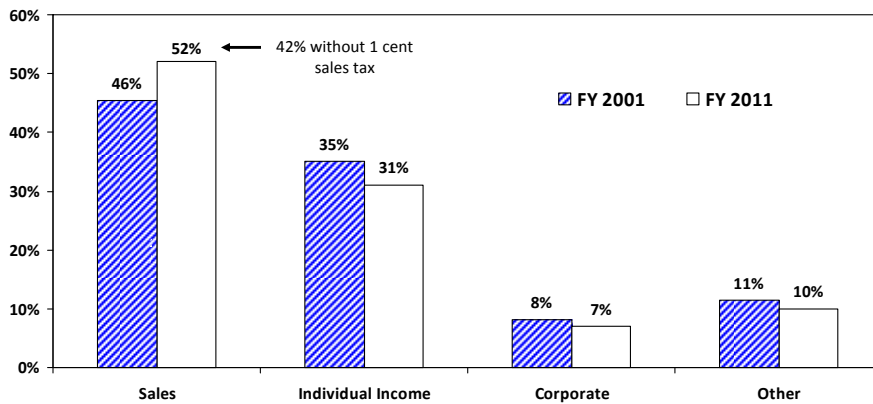


^{1/} January 2011 estimate. Excludes beginning balance, urban revenue sharing, and one-time revenue adjustments.

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Since '01, Greater Reliance on Sales Tax Due to 1 Cent Tax Increase

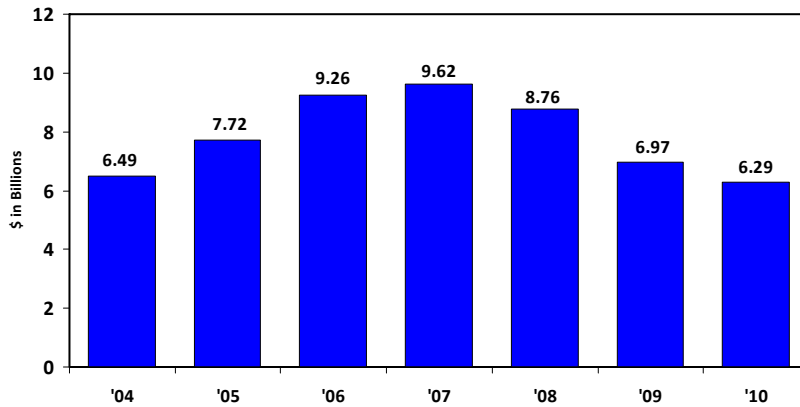


- Excludes beginning balance, urban revenue sharing, and one-time revenue adjustments.

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Unprecedented 3 Year General Fund Revenue Decline Of (33)%



- Excludes statutory and one-time changes.

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Revenue Update - Base Growth of 7.4% Through December - May Not Be Sustainable for Entire Fiscal Year

	YTD FY '11 Over YTD FY '10
Sales Tax	-0.6%*
Individual Income Tax	9.7%
Corporate Income tax	115.4%

* Without 1 Cent

- Unusually low '10 collections and higher business profits boosted corporate %.
- Individual Income Tax artificially high due to withholding change.
- After negative summer, sales tax collections are beginning to turn positive.
- Revenues \$(18) M below budget through 12/2010.

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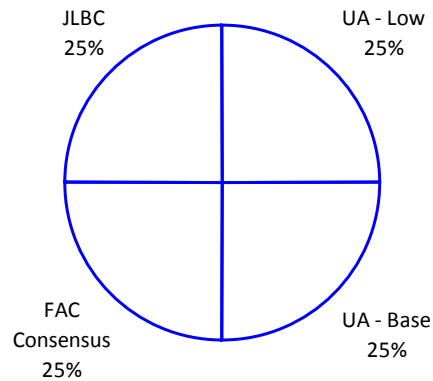
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Where Are We Headed Over the Next Few Years?

- Four-Sector Consensus Forecast Incorporates Different Economics 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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Any Revenue Forecast Will Have Significant Constraints In Predicting the Next 18 Months

- Current economic instability makes forecasting especially challenging.
- 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.

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The Road to Recovery Will Still Be Long

- 265,000 jobs lost since December 2007
 - Have gained 32,000 jobs in the last year.

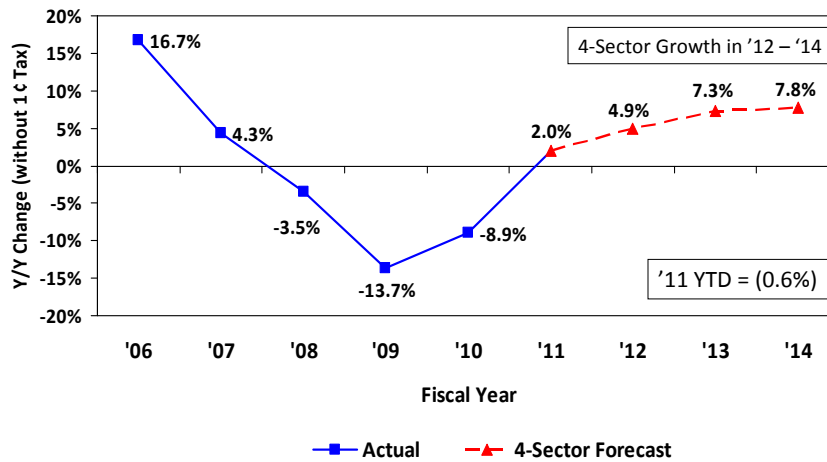
- Housing problems persist
 - While pending Valley foreclosures declined from 51,000 in December 2009, there are still 41,000 in the pipeline
 - 49% of Arizona-wide mortgages “underwater”

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Sales Tax

- Collections (excl. 1¢ tax) forecast to be \$3.62 B in FY '12

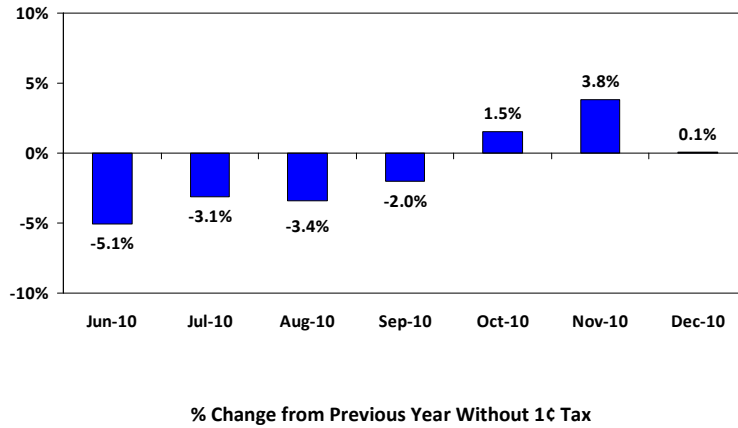


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Percentage Changes Are Prior To Tax Law Changes

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While Sales Tax Collections Are (0.6)% Year to Date, Recent Months Have Been Positive

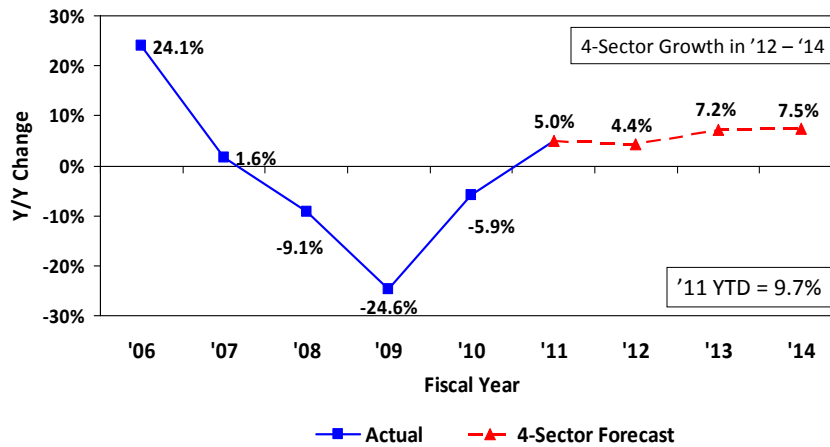


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Individual Income Tax

- Net Collections forecast to be \$2.67 B in FY '12



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Percentage Changes Are Prior To Tax Law Changes
Without tax law changes, growth would have been 6.3% in FY '07 and (4.1)% in FY '08

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Individual Income Tax Growth Is Artificially Inflated Due To New Withholding Tables

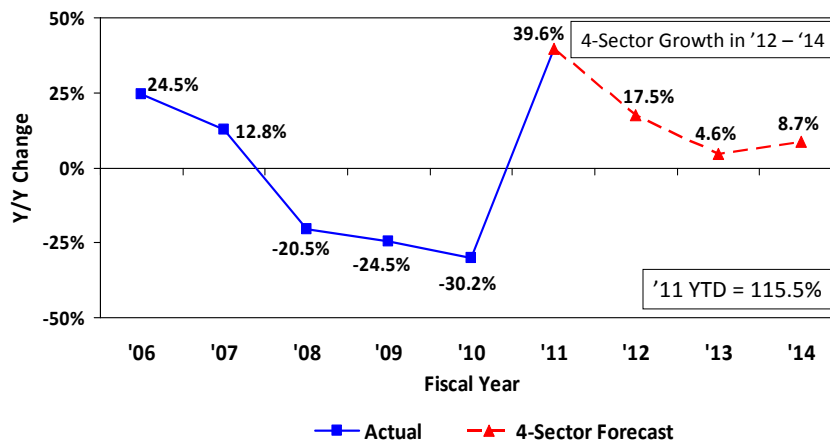
- ❑ Net collections are up by 9.7% through December.
- ❑ No evidence that wage and job growth is that high.
- ❑ In July '10, state began to use new withholding tables – used to be % of federal withholding, now % of income
- ❑ Withholding changes are never exact science – difficult to match prior amount of withholding.
- ❑ As a result, 9.7% growth may be due to over-withholding of taxpayers' paychecks. Refunds are expected to be higher when tax returns are filed.

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Corporate Income Tax

- Net Collections forecast to be \$674 M in FY '12



Percentage Changes Are Prior To Tax Law Changes

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Without tax law changes, decline would have been (17.2)% in FY '08, (20.7)% in FY '09, and (18.7)% in FY '10 ¹⁴

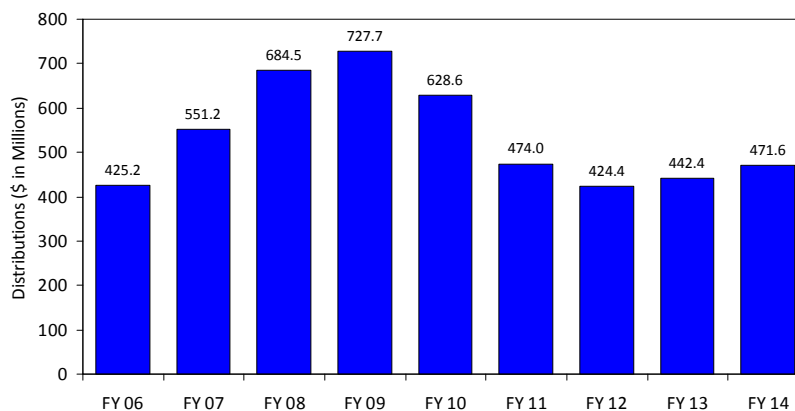
Corporate Income Tax Could Experience Large % Gain in FY '11 – But Will Not Double

- ❑ Net collections are up by 115% through December.
- ❑ FY '10 corporate refunds were inflated by extraordinarily large returns in November 2009.
- ❑ In FY '10, collections declined by (63)% in the 1st half of year compared to an increase of 5% in the 2nd half – as a result, expect lower % growth for rest of FY '11.
- ❑ Nonetheless, increased profitability is expected to generate double-digit growth in collections in FY '11.

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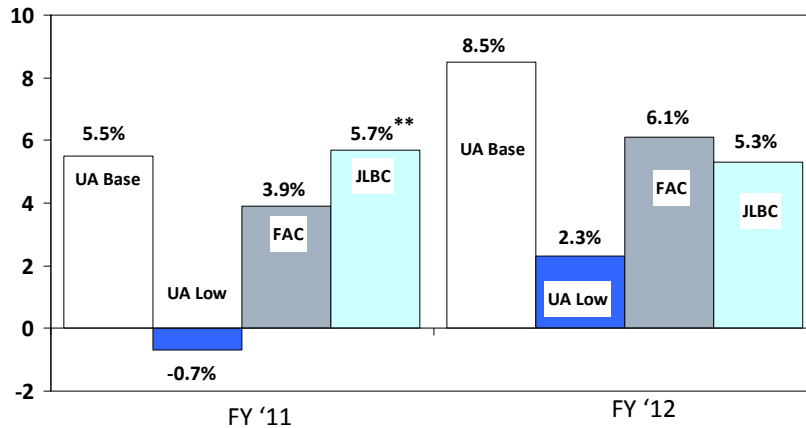
Urban Revenue Sharing Will Decline \$(50)m in '12 – 2-year lagged link to income tax causes the drop



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Consensus Predicts Growth of 3.3% in FY '11 and 5.4% in FY '12*



Details in Appendix A

* Weighted Big 3 average growth prior to 1 ¢ sales tax and adjusted for tax law changes.

** Once adjusted for small revenue categories, growth rate is 5.2%

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Rather Than Consensus, JLBC Recommends Using Its FY '11 Base Growth Rate of 5.2%

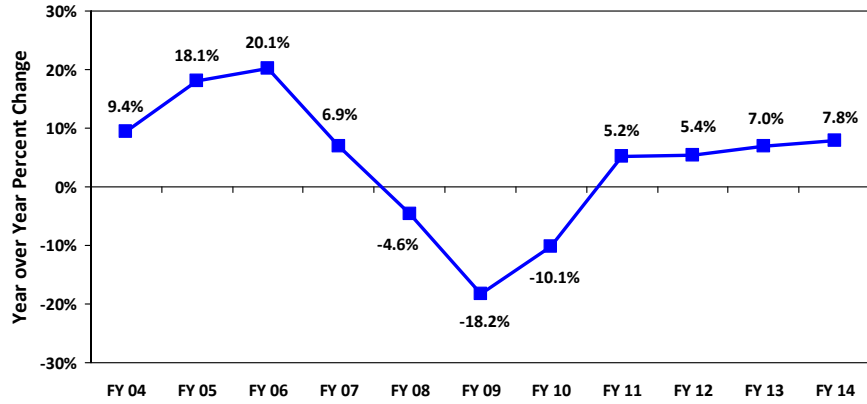
- ❑ While FY '12 growth is reasonable, FY '11 Consensus growth of 3.3% appears low. Year-to-date growth is 7.4%.
- ❑ The forecast of 5.2% requires revenues to grow by 2.9% in the second half of FY '11.
- ❑ May not sustain 7.4% growth for full year. Year-to-date growth is artificially inflated for 2 reasons:
 - Corporate unlikely to double collections by end of the year
 - Individual income tax collections inflated by taxpayer over-withholding due to withholding table change in July 2010

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Consensus Forecasts Base Revenue Growth Rate Above 5% Thru FY '14

– On A Comparable Basis, Executive Forecasts 4.5% in '11 and 7.1% in '12



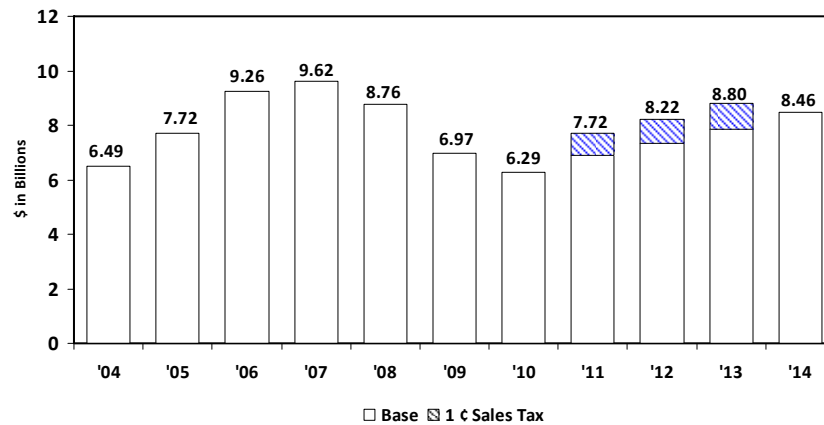
- To reflect underlying economic growth, "Base" revenues exclude balance forward, tax law changes, one-time revenues, and urban revenue sharing

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Consensus Forecasts Still Below FY '07 Level

– On A Comparable Basis, Executive Is \$8 M Higher in '11 and \$135 M in '12 Than JLBC Baseline



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

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How Does New Forecast Affect Budget Shortfall?

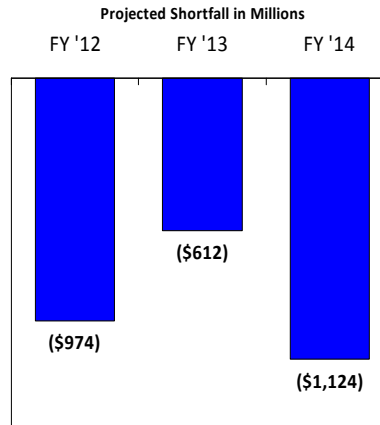
FY '11 Shortfall Now Estimated at \$(531) M - Down from \$(825) M

- Failure of November ballot props – \$(469) M
- Projected revenue shortfall – \$(86) M
 - Prior estimate was \$(200) M
 - Decline mostly due to lag in 1-cent sales tax
- Projected Health/Welfare Caseload Savings – \$19 M
 - Prior \$(158) M lower Federal match shortfall offset by caseload savings and rate cut
- \$100 M K-12 shortfall – offset with federal funds

A Projected Cash Shortfall Of \$(974) M In FY '12

- Any Permanent Solutions in FY '12 Reduce FY '13 and FY '14 Gaps

- Based on consensus revenues and active formula growth
- FY '12: Federal assistance expires
- FY '14: Sales tax expires and increases shortfall
- Does not include \$1 B+ In suspended formulas (Appendix B)

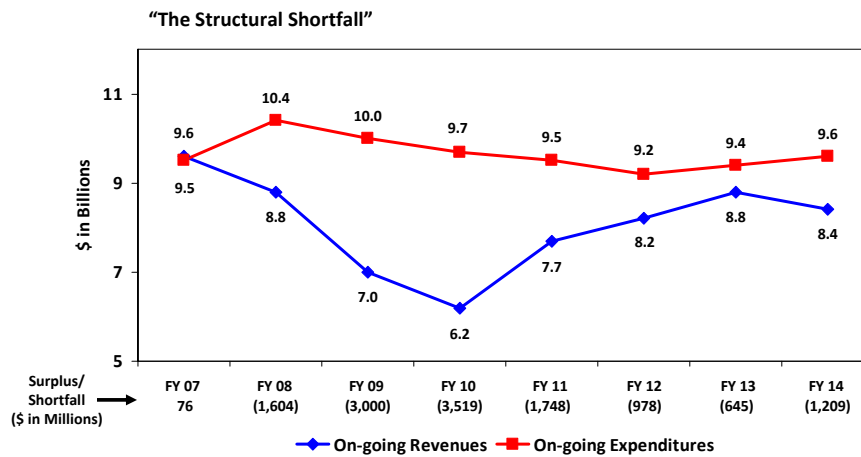


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Structural Gap Comparable to Cash Gap in FY '12-'14

- Represents On-Going Revenues Versus On-Going Expenditures



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Another Aspect of State's Fiscal Policy Is its Credit Rating - Arizona's Rating Is 3rd Lowest of All States

- Arizona Financing is Investment Grade – 5th highest level (out of 10) for GF-backed financing
- Recent downgrade due to:
 - Economic and financial weakness
 - Structural imbalance and reliance on one-time solutions
 - Constitutional limits on raising revenues and reducing spending
- But outlook has shifted from “negative” to “stable” reflecting:
 - Recent revenue improvement
 - Recent efforts to reduce structural deficit

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Appendix A: January 2011 4-Sector Forecast

	FY 2011	FY 2012	FY 2013	FY 2014
Sales Tax				
JLBC Forecast	2.0%	5.0%	7.0%	7.2%
UA – Low	-2.8%	3.1%	6.3%	8.5%
UA – Base	0.0%	7.6%	9.2%	9.3%
FAC	0.8%	4.0%	6.7%	6.2%
Average:	0.0%	4.9%	7.3%	7.8%
Individual Income Tax				
JLBC Forecast	5.0%	6.4%	7.0%	7.2%
UA - Low	3.1%	-1.1%	6.4%	8.1%
UA – Base	13.4%	5.8%	8.0%	8.3%
FAC	5.1%	6.6%	7.3%	6.2%
Average:	6.6%	4.4%	7.2%	7.5%
Corporate Income Tax				
JLBC Forecast	39.6%	2.3%	7.5%	13.2%
UA – Low	-6.0%	17.4%	-1.7%	6.0%
UA – Base	3.8%	33.1%	-1.4%	3.7%
FAC	21.9%	17.1%	13.8%	12.0%
Average:	14.8%	17.5%	4.6%	8.7%
JLBC Weighted Average:	5.2%*	5.3%	7.0%	7.7%
UA Low Weighted Average	-0.7%	2.3%	5.8%	8.2%
UA Base Weighted Average	5.5%	8.5%	7.9%	8.5%
FAC Weighted Average:	3.9%	6.1%	7.6%	6.8%
Consensus Weighted Average:	3.3%*	5.4%*	7.0%	7.8%

* JLBC and Consensus forecast adjusted for tax law changes and small revenue categories

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Appendix B: Funding Formula Suspensions for FY 2012

<u>Agency</u>	<u>Formula</u>	<u>Savings</u>
Community College	Operation and Equalization Formula	\$9,028,800
Department of Education	Capital State Aid Suspension	\$22,155,200
	Soft-Capital Formula	\$165,120,700
	New Utilities Formula	\$100,000,000
Department of Emergency & Military Affairs	Charter School Additional Assistance	\$10,000,000
	Military Installation Fund Deposit	\$2,800,000
	Governor's Emergency Fund	\$2,100,000
Department of Environmental Quality	WQARF	\$8,000,000
Judiciary	Probation Revocation Payment	\$2,410,300
School Facilities Board	Building Renewal	\$241,593,600
Tourism	Tourism Funding Formula	\$14,350,100
State Treasurer	Justice of the Peace Salaries	\$1,115,000
Universities	Financial Aid Trust	\$4,089,600
Department of Water Resources	Water Protection Fund Transfer	<u>\$5,000,000</u>
Subtotal		\$587,763,300
Future Year Cost – Department of Education	Teacher Performance Pay (by FY 2018)	\$278,000,000
Future Year Cost – School Facilities Board	New School Construction (if enrollment returns to pre-recession level)	<u>\$386,000,000</u>
Total		\$1,251,763,300
Department of Administration	Building Renewal	\$38,710,500
Universities	Enrollment	\$28,432,000
	Building Renewal	<u>\$90,136,900</u>
Subtotal		\$157,279,400

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