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# **Finance Advisory Committee**

## **Revenue and Budget Update**

**October 11, 2018**

**JLBC**

# Key Points

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- ❑ Strong economic growth has substantially improved the state's fiscal condition
- ❑ The General Fund is forecast to have a structural balance of \$200 M +
- ❑ In addition, the state is expected to have a 1-time balance of \$900 M + in '20

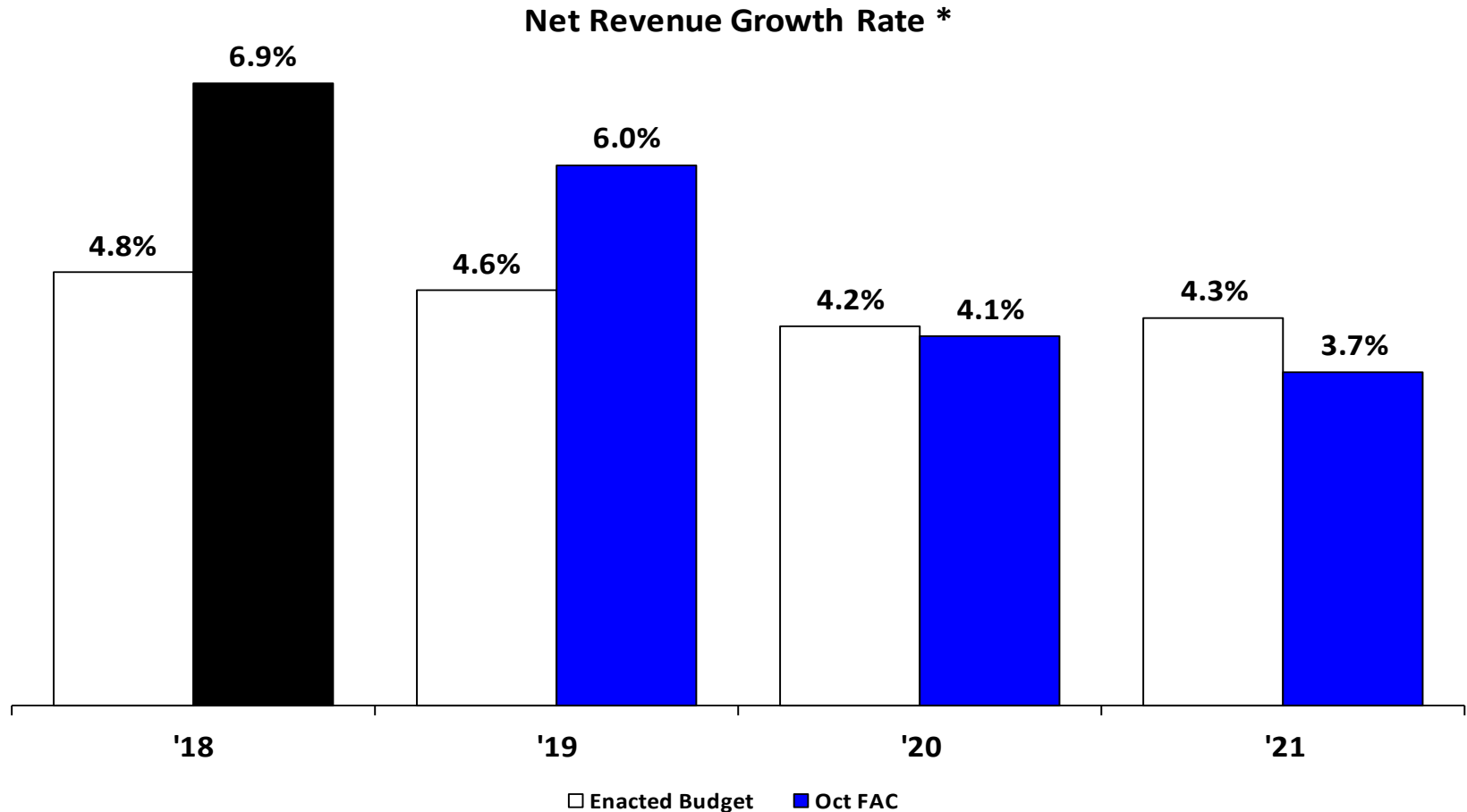
# How Did We End Up with \$1 B Above Forecast

- Enacted budget assumed a \$188 M balance in '20
- '20 Balance is now forecast at \$1.1 B: \$200 M ongoing + \$900 M 1-time

	\$ in M			
<u>Changes to '19's 3-Year Plan</u>	<u>'18</u>	<u>'19</u>	<u>'20</u>	<u>Total</u>
Higher '18 Revenue Base	212	222	231	665
New '19/'20 Revenue Forecast	-	155	147	302
Revised Spending/URS	13	(13)	(5)	(5)
Total	<u>225</u>	<u>364</u>	<u>373</u>	<u>962</u>

# '18 & '19 Forecast Above Enacted Budget

## - Primary Reason for Projected Surplus



\*Excludes Balance Forward, Budgeted Fund Transfers and URS

# Forecast Assumption I

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- ❑ Continued strong revenue growth of 6.0% in '19, moderating to near 4% in '20 and beyond
- ❑ At least in short-run, strong economy has slowed Medicaid growth
- ❑ No recession in the 3-year planning horizon through '22

# Wide Divergence in National Forecasts

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## ☐ Fed Chair:

- “Remarkably positive” period that pairs “steady, low inflation and very low unemployment”

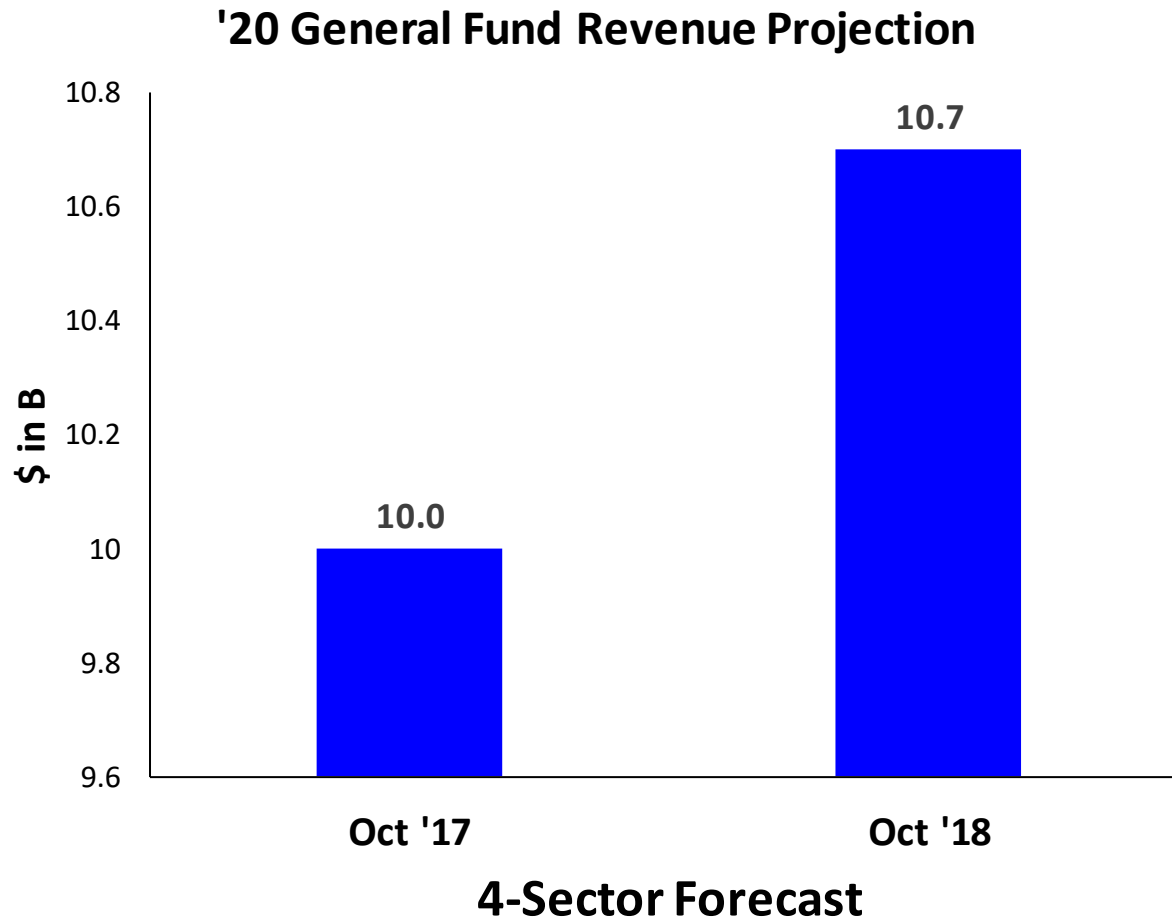
## ☐ Poll of 51 national economic forecasters:

- 66% predict a recession by end of CY ‘20

# Forecast Has Changed by \$700 M in a Year

- Could Happen Again Up or Down by October 2019

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# Forecast Assumption II

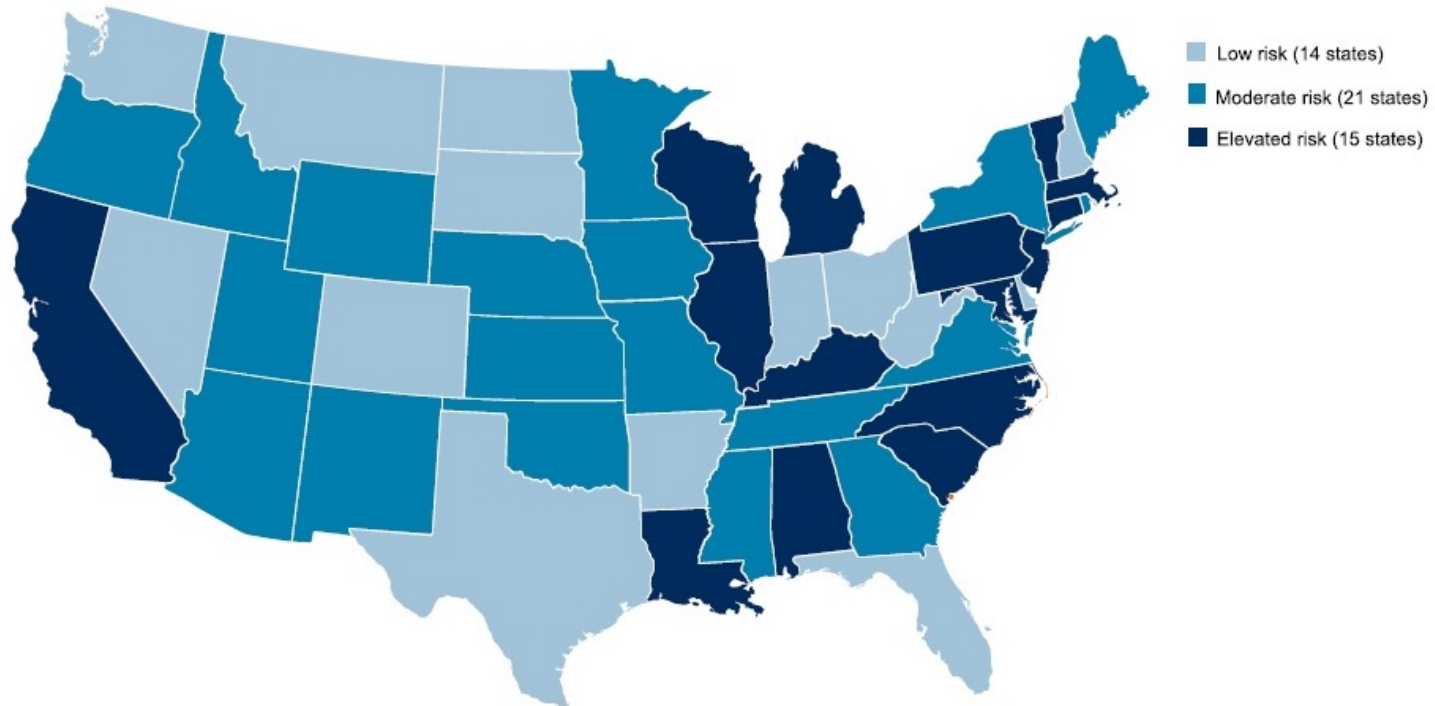
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- ❑ The '20 budget will allocate the 1-time balance rather than roll those resources into '21
  
- ❑ Options for Allocating 1-Time Monies
  - Continue the \$80 M in reoccurring “1-time” ‘19 monies
  - Budget Stabilization Fund Deposit (aka Rainy Day Fund)
  - K-12 Building Repairs and Other Capital Projects
  - Debt Repayment
  - Buy down of \$930 M K-12 Rollover



# Is AZ Prepared for a Recession?

- Standard and Poor's Report: No



Source: S&P Global Ratings.  
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- ❑ S&P: Arizona is at moderate risk in a recession
- ❑ Reserves as a % of Fiscal Shock Impact: 35% - 43%

# Forecast Assumption III

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- ❑ Does not address Federal Tax Conformity
  - If take no action, revenues would not change
  - If conform, state could generate \$133 M to \$236 M
- ❑ Does not address US Supreme Court Wayfair ruling
  - Allows states to levy TPT on online out-of-state sellers
  - If enacted, may generate \$85 M ????
- ❑ Does not address US Supreme Court sports betting ruling
  - Allows states to authorize sports betting

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# Revenue Forecast

# Arizona Ranks 6<sup>th</sup> in Economic Momentum

- 5<sup>th</sup> in April

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	<u>AZ Rate</u>	<u>AZ Rank</u>
<input type="checkbox"/> Change in Personal Income (June)	5.6%	6
<input type="checkbox"/> Change in Population (July)	1.6%	6
<input type="checkbox"/> Change in Employment (August)	2.9%	6
<input type="checkbox"/> Unemployment Rate (August)	4.6%	44

Momentum calculations via State Policy Reports – Joint NGA/NCSL Project

# '19 YTD: 10.7% Growth/\$183 M Above Forecast

- '18 Was \$212 M Above Budget

	<u>% Growth Above Prior Year</u>		<u>'19 +/- Forecast (\$ M)</u>
	<u>'18 Actual</u>	<u>'19 YTD</u>	
Sales	6.2%	7.1%	\$ 42
Individual Income	10.0	9.4	62
Corporate Income	1.3	79.6	64
Insurance Premium	1.0	(4.5)	2
Other	(2.3)	71.8	13
Overall *	<u>6.9%</u>	<u>10.7%</u>	<u>\$ 183</u>

\* Revenues exclude fund transfers and Urban Revenue Sharing. Represents preliminary September data.

# Strong '19 Growth, then Modest Gains

## October Consensus Forecast

- Finance Advisory Committee
- UA model – base
- UA model – low
- JLBC Staff

## Represents Net Growth

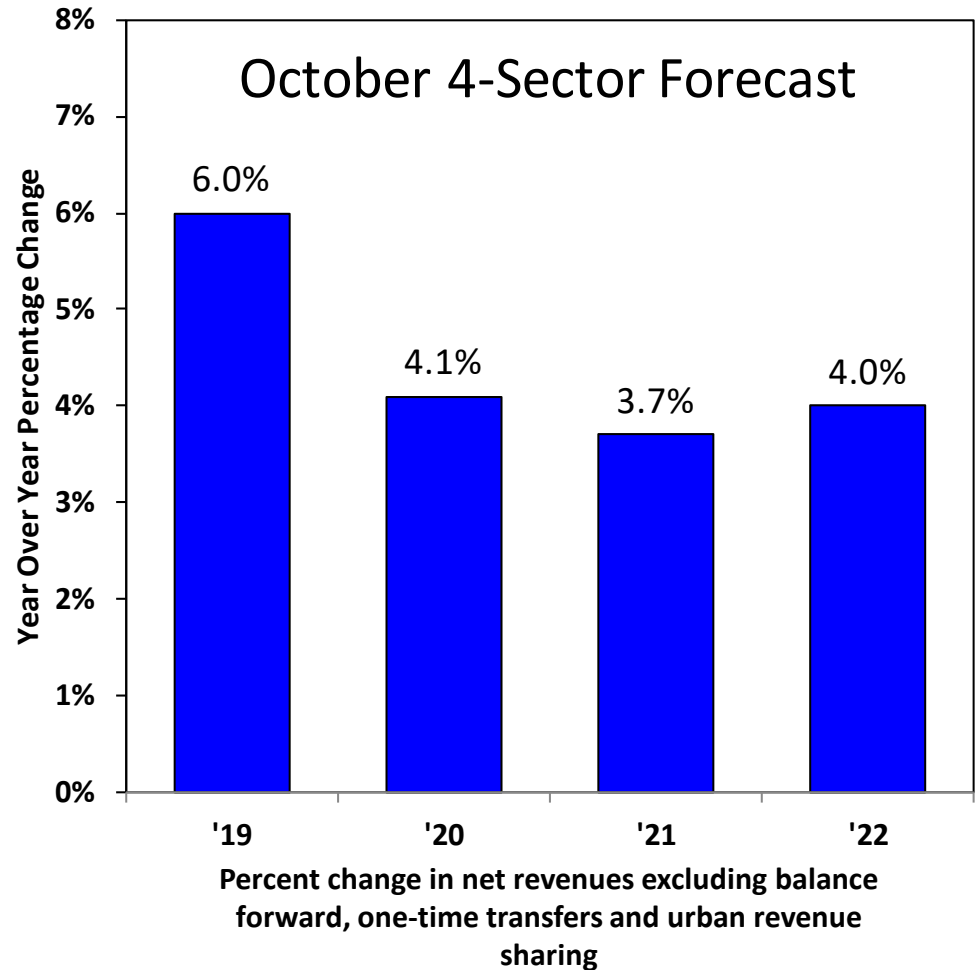
- Previously estimated gross

## Chance of Exceeding Forecast

- 60%

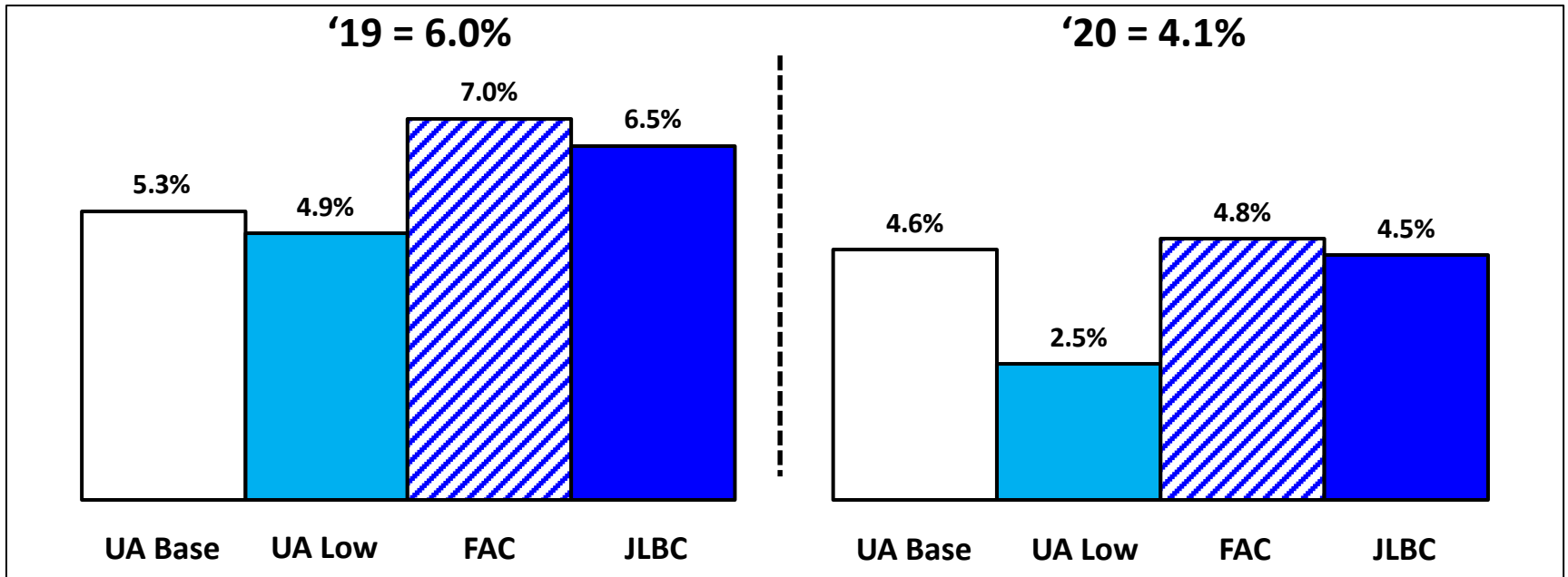
## Long Run Average Growth

- 4.25%



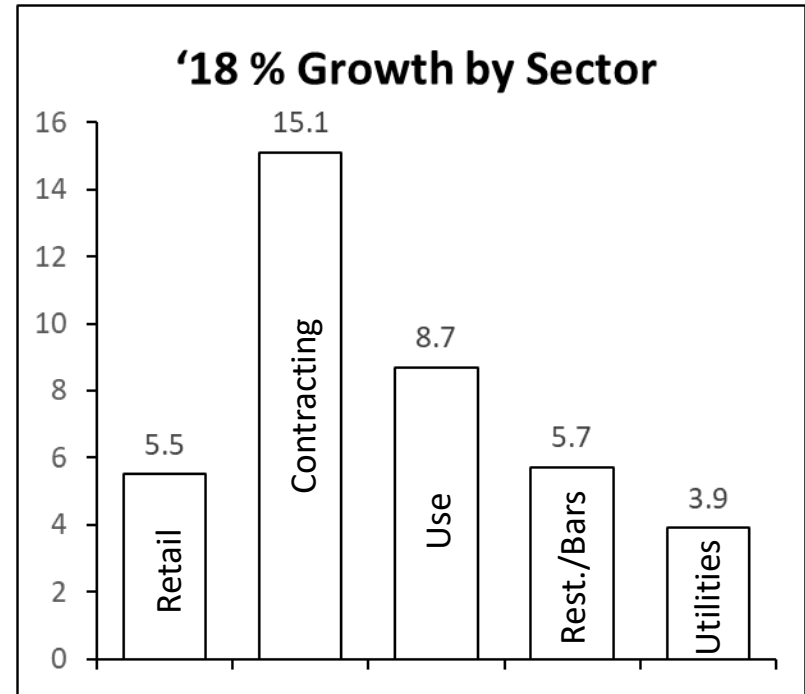
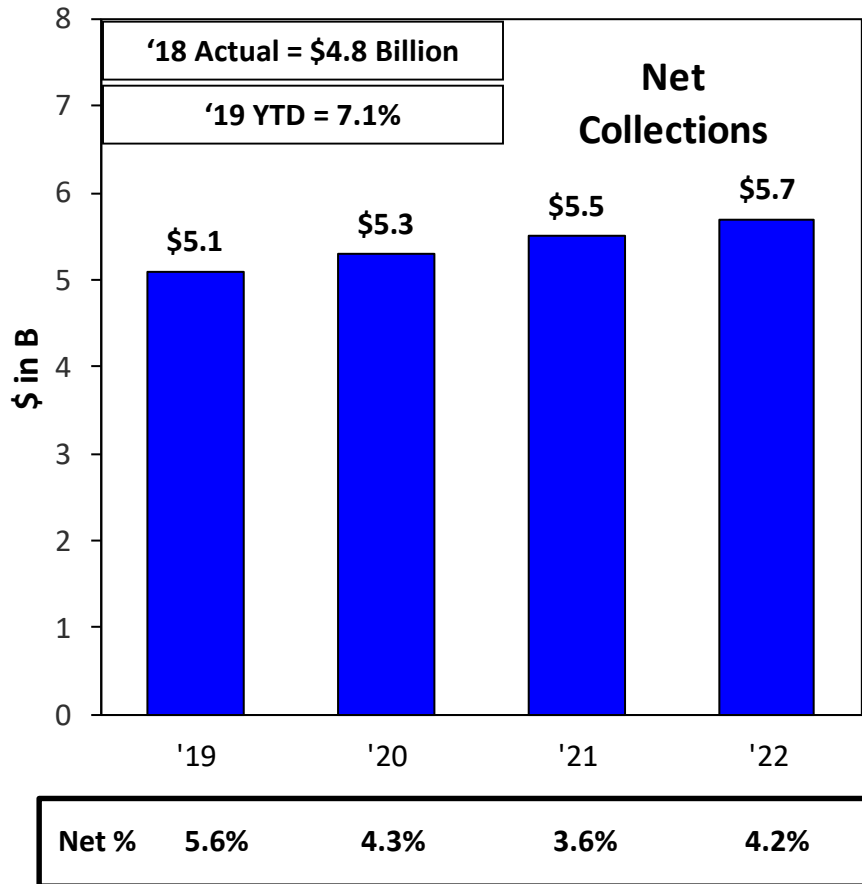
See Appendix A, B C, & D

# “UA Low” Adds More Caution to Forecast



- ❑ “UA Low” is a slower growth scenario; not a recession
- ❑ ... but we are approaching historical length of expansion

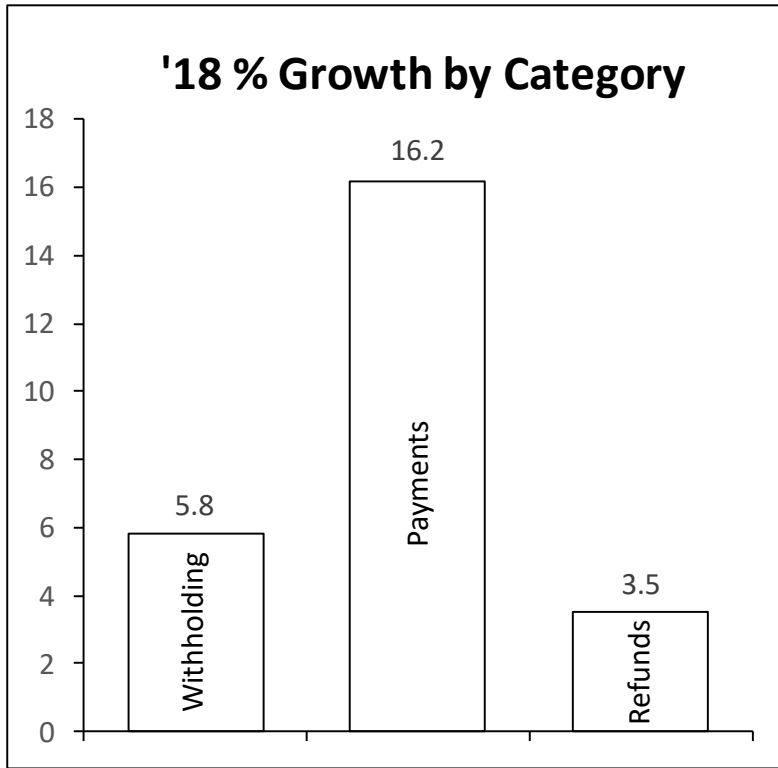
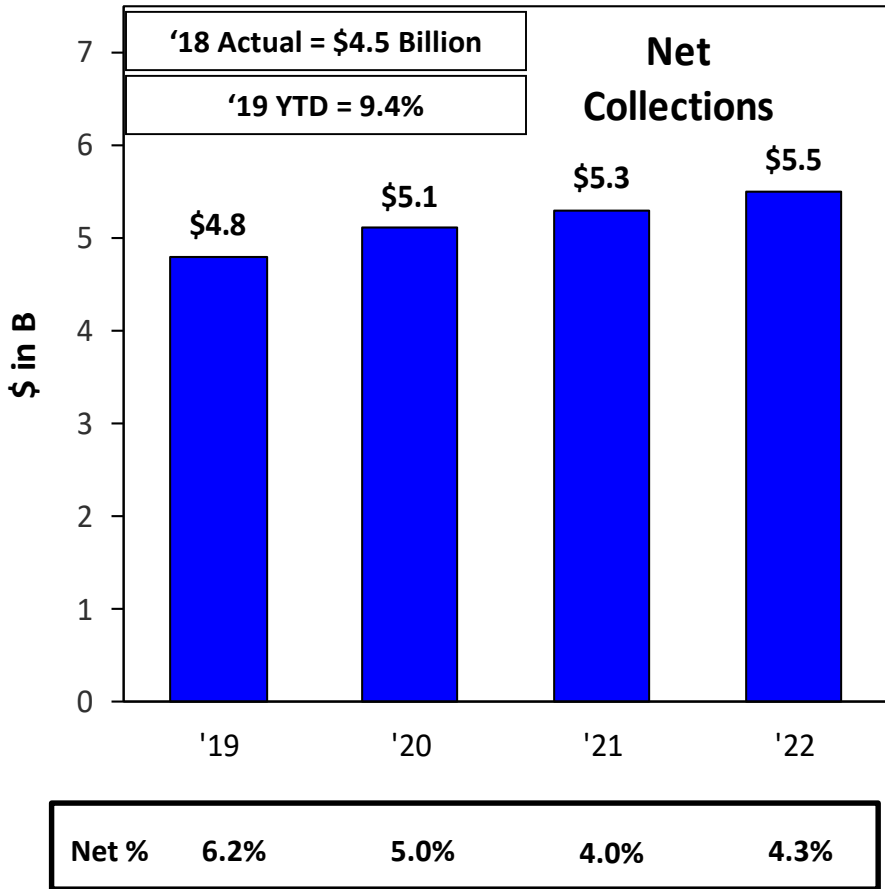
# Sales Tax



- Overall '18 growth of 6.2%
- Highest growth since '06



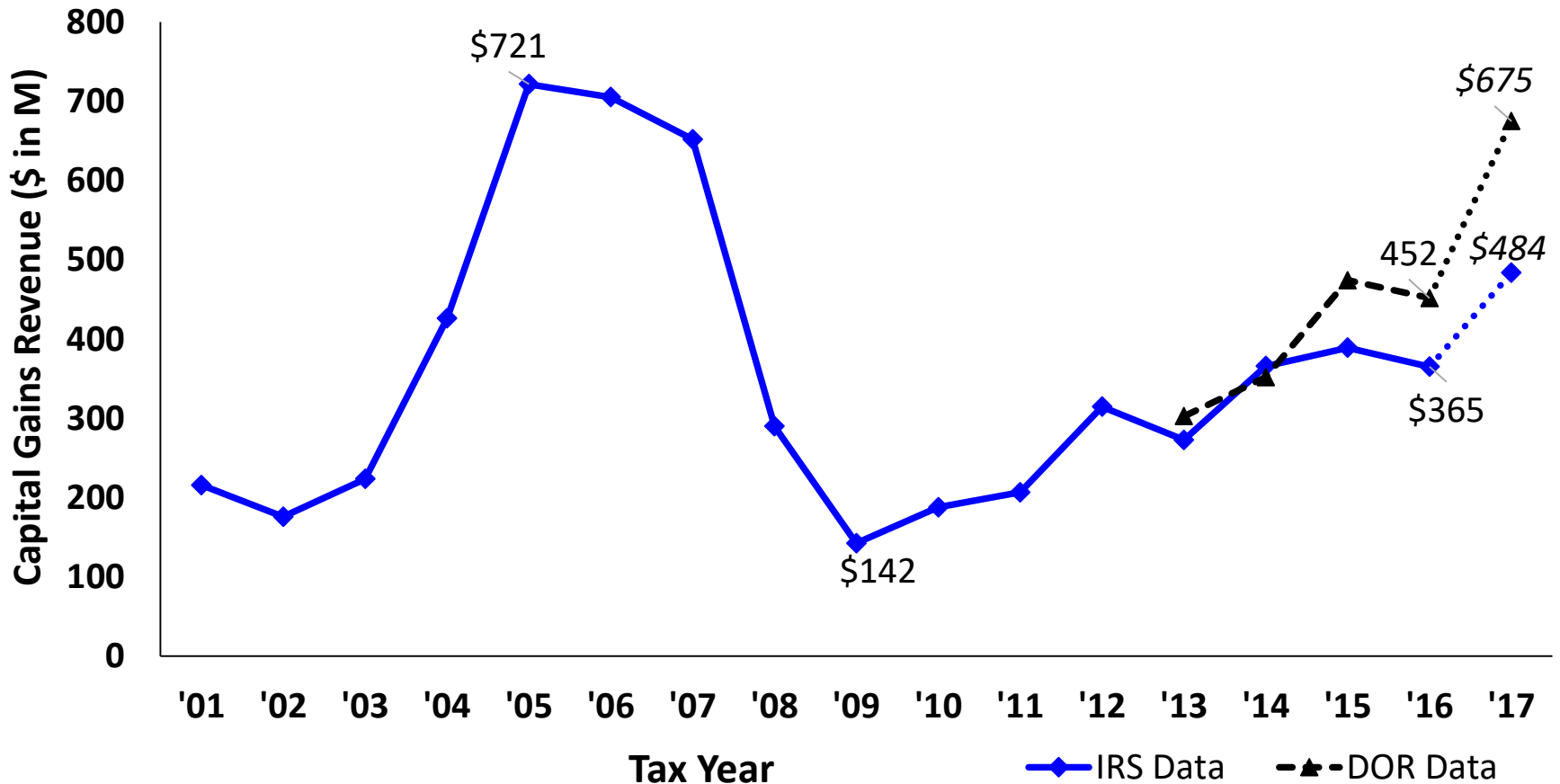
# Individual Income Tax



- Overall '18 growth of 10.0%
- Capital Gains fueled payments growth

# Volatility of Capital Gains Revenues

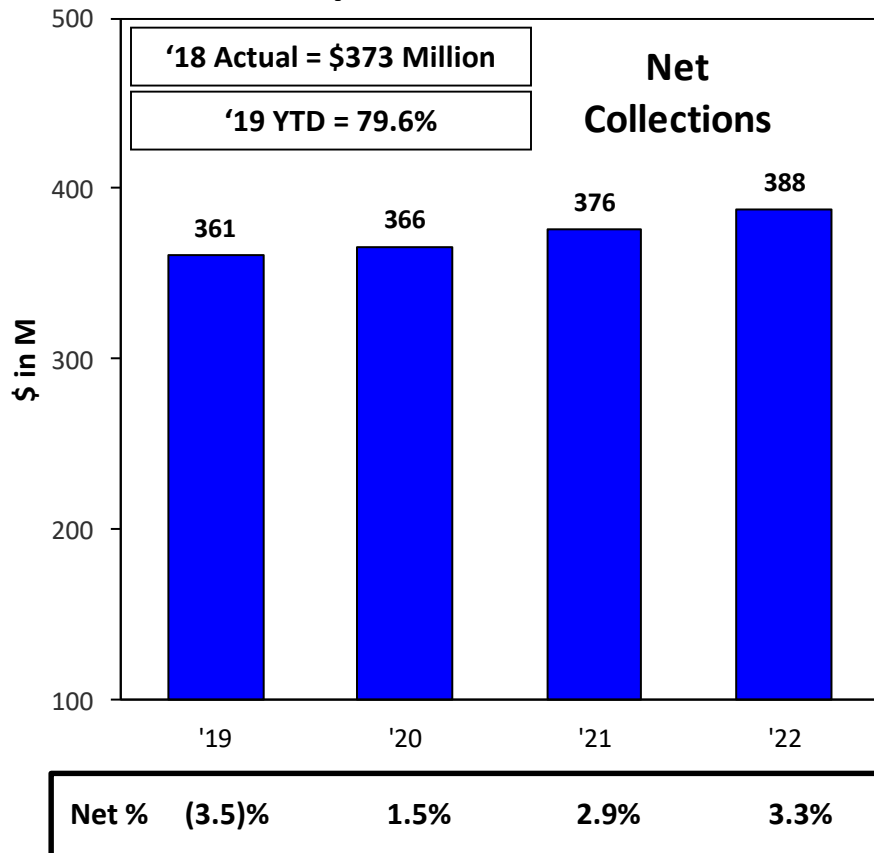
## Spike in TY '17 Capital Gains Affects '18 IIT Payments



- To calculate capital gains revenue, JLBC Staff applied the average of the top 2 marginal IIT rates to the capital gains income reported by both DOR and the IRS.
- IRS data excludes non-resident filers.

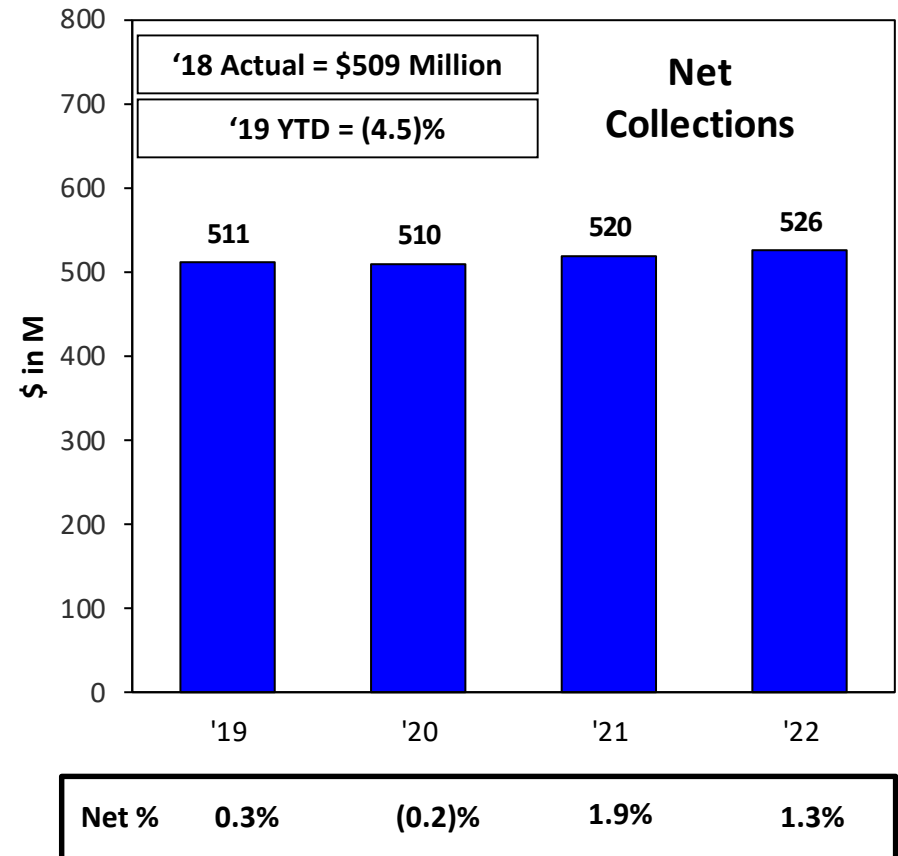
# Corporate Income Tax and Insurance Premium Tax

## Corporate Income Tax



- '19 Completes Tax Cut Phase-in
- Large YTD growth caused forecast to be revised up

## Insurance Premium Tax



- Individual Mandate Repeal/Lower AHCCCS caseloads slowed growth

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# Spending Forecast

# '20 – '22 Baseline Spending Projections

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- ❑ Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- ❑ Continues annual suspension of \$456 M of inactive statutory formulas
- ❑ Continues \$930 M in K-12 “rollover” payments
- ❑ Assumes spending classified as one-time or expiring in '19 budget does not continue

# Projected Baseline Spending Increases by \$352 M

'20 Ongoing Spending Changes	
	<u>\$ in M</u>
ADE – K12 Formula	424
DES – Medicaid Formula	51
AHCCCS – Medicaid Formula	28
Judiciary – Maricopa Judges	7
Sec. of State – Presidential Primary	5
Commerce Authority	(6)
DPS – Highway Fee Shift	(22)
Other	<u>(6)</u>
<b>Total</b>	<b>481</b>

'20 One-Time Spending Deletions	
	<u>\$ in M</u>
SFB Fewer New Buildings	(38)
SFB Building Repairs	(34)
DES Prop 206 Costs	(13)
Counties	(13)
Universities	(11)
Employee Health	(10)
Capital Projects	(5)
Other	<u>(5)</u>
<b>Total</b>	<b>(129)</b>

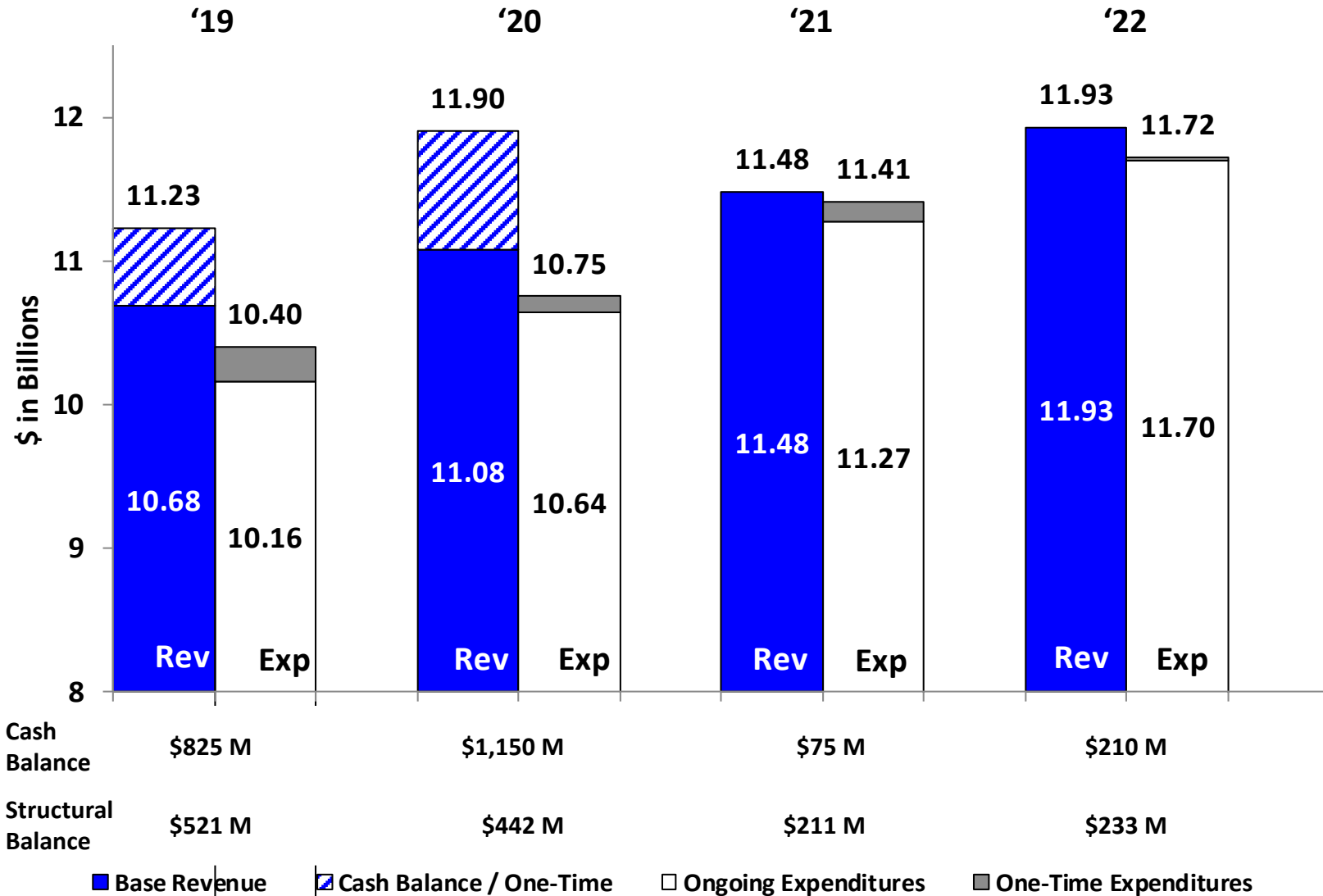
<b>Total Spending Changes</b>	<b>\$352 M</b>
<b>Total Spending</b>	<b>\$10,755</b>
<b>% Change</b>	<b>3.4%</b>

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# **Cash and Structural Balance Forecast**

# Long Run Budget Permits \$200 + M in Ongoing Initiatives

## - Assumes No Discretionary Changes





# Litigation Could Impact the Bottom Line

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- Rental Car Surcharge
- DCS Foster Care
- K-12 Capital

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# Appendices

# Appendix A: October 2018 4-Sector Forecast

	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>
<b>Sales Tax</b>				
JLBC Forecast	5.5%	5.0%	4.5%	4.3%
UA – Low	5.2%	2.2%	1.6%	4.4%
UA – Base	5.7%	5.0%	4.6%	4.6%
FAC	6.0%	5.0%	3.7%	3.6%
Average:	<b>5.6%</b>	<b>4.3%</b>	<b>3.6%</b>	<b>4.2%</b>
<b>Individual Income Tax</b>				
JLBC Forecast	6.9%	4.9%	4.0%	3.3%
UA – Low	5.0%	3.8%	2.7%	4.4%
UA – Base	5.4%	5.5%	4.9%	5.0%
FAC	7.6%	5.8%	4.5%	4.3%
Average:	<b>6.2%</b>	<b>5.0%</b>	<b>4.0%</b>	<b>4.3%</b>
<b>Corporate Income Tax</b>				
JLBC Forecast	6.5%	3.6%	2.0%	3.0%
UA – Low	-14.1%	-1.8%	2.3%	4.2%
UA – Base	-12.7%	1.2%	4.6%	4.9%
FAC	6.4%	2.5%	2.8%	1.5%
Average:	<b>-3.5%</b>	<b>1.5%</b>	<b>2.9%</b>	<b>3.3%</b>
<b>Insurance Premium Tax</b>				
JLBC Forecast	0.0%	1.0%	2.0%	1.3%
UA – Low	0.3%	-2.0%	2.0%	0.7%
UA – Base	0.4%	-1.4%	1.9%	1.6%
FAC	0.5%	1.8%	1.8%	1.5%
Average:	<b>0.3%</b>	<b>-0.2%</b>	<b>1.9%</b>	<b>1.3%</b>

JLBC Weighted Average	<b>5.9%</b>	<b>4.7%</b>	<b>4.1%</b>	<b>3.7%</b>
UA Low Weighted Average	<b>4.2%</b>	<b>2.6%</b>	<b>2.1%</b>	<b>4.2%</b>
UA Base Weighted Average	<b>4.6%</b>	<b>4.8%</b>	<b>4.6%</b>	<b>4.7%</b>
FAC Consensus Weighted Average	<b>6.4%</b>	<b>5.1%</b>	<b>4.0%</b>	<b>3.8%</b>
“Big-4” Weighted Average	<b>5.3%</b>	<b>4.3%</b>	<b>3.7%</b>	<b>4.1%</b>
Consensus Weighted Average*	<b>6.0%</b>	<b>4.1%</b>	<b>3.7%</b>	<b>4.0%</b>

\* Represents ongoing revenue adjusted for small revenue categories.

# Appendix B: General Fund Revenue FY '18 - FY '20

## FORECAST REVENUE GROWTH

(\$ in Thousands)

	ACTUAL FY 2018	% CHANGE PRIOR YR	FORECAST FY 2019	% CHANGE PRIOR YR	\$ CHANGE PRIOR YR	FORECAST FY 2020	% CHANGE PRIOR YR	\$ CHANGE PRIOR YR
Sales and Use	4,787,647.2	6.2%	5,055,242.5	5.6%	267,595.3	5,272,458.0	4.3%	217,215.6
Income - Individual	4,544,081.2	10.0%	4,826,463.4	6.2%	282,382.2	5,067,807.5	5.0%	241,344.1
- Corporate	373,076.4	1.3%	360,085.3	-3.5%	(12,991.1)	365,650.4	1.5%	5,565.0
Property	38,719.6	19.0%	36,598.5	-5.5%	(2,121.1)	36,094.5	-1.4%	(504.1)
Luxury - Tobacco	21,978.2	-4.2%	21,206.9	-3.5%	(771.3)	20,445.3	-3.6%	(761.5)
- Liquor	36,019.7	3.8%	36,976.3	2.7%	956.6	37,951.3	2.6%	975.0
Insurance Premium	509,276.0	1.0%	510,849.3	0.3%	1,573.3	510,025.5	-0.2%	(823.8)
Other Taxes	7,650.5	179.1%	12,781.9	67.1%	5,131.4	13,506.4	5.7%	724.4
Subtotal - Taxes	10,318,448.8	7.5%	10,860,204.1	5.3%	541,755.4	11,323,938.8	4.3%	463,734.7
<b>Other Non-Tax Revenues:</b>								
Lottery	68,425.4	-13.0%	84,506.5	23.5%	16,081.1	94,113.4	11.4%	9,606.9
Licenses, Fees and Permits	37,969.9	-1.2%	34,206.9	-9.9%	(3,763.0)	35,130.4	2.7%	923.5
Interest	22,013.1	29.5%	35,000.0	59.0%	12,986.9	42,378.6	21.1%	7,378.6
Sales and Services	34,120.9	-18.9%	44,326.2	29.9%	10,205.3	38,163.7	-13.9%	(6,162.5)
Other Miscellaneous	108,311.8	29.1%	84,997.6	-21.5%	(23,314.1)	87,488.5	2.9%	2,490.9
Transfers and Reimbursements	40,598.6	-36.7%	124,908.2	207.7%	84,309.6	111,244.7	-10.9%	(13,663.5)
Disproportionate Share Revenue	83,704.7	-11.3%	83,604.0	-0.1%	(100.7)	83,189.0	-0.5%	(415.0)
Subtotal - Other Non-Tax	395,144.3	-5.6%	491,549.5	24.4%	96,405.2	491,708	0.0%	158.9
<b>Net On-Going Revenue</b>	<b>10,713,593.0</b>	<b>6.9%</b>	<b>11,351,753.6</b>	<b>6.0%</b>	<b>638,160.5</b>	<b>11,815,647.2</b>	<b>4.1%</b>	<b>463,893.6</b>
Urban Revenue Sharing (URS)	(680,770.1)	N/A	(674,804.4)	N/A	5,965.6	(737,573.6)	N/A	(62,769.2)
<b>Net Ongoing Revenue w/ URS</b>	<b>10,032,822.9</b>	<b>7.2%</b>	<b>10,676,949.2</b>	<b>6.4%</b>	<b>644,126.2</b>	<b>11,078,073.6</b>	<b>3.8%</b>	<b>401,124.5</b>
<b>One-Time Financing Sources:</b>								
Fund Transfers	66,219.0	-54.4%	100,681.7	52.0%	34,462.7	1,840.7	-98.2%	(98,841.0)
Moody's Settlement Fund Transfer	8,172.7	N/A	0.0	-100.0%	(8,172.7)	0.0	N/A	0.0
Subtotal - One-Time Financing Sources	74,391.7	-48.7%	100,681.7	35.3%	26,290.0	1,840.7	-98.2%	(98,841.0)
<b>Subtotal - Revenues</b>	<b>10,107,214.6</b>	<b>6.4%</b>	<b>10,777,630.9</b>	<b>6.6%</b>	<b>670,416.2</b>	<b>11,079,914.3</b>	<b>2.8%</b>	<b>302,283.5</b>
Balance Forward	150,871.0	-46.9%	449,632.0	198.0%	298,761.0	824,804.0	83.4%	375,172.0
<b>Total - Resources</b>	<b>10,258,085.6</b>	<b>4.8%</b>	<b>11,227,262.9</b>	<b>9.4%</b>	<b>969,177.2</b>	<b>11,904,718.3</b>	<b>6.0%</b>	<b>677,455.5</b>

# Appendix B: General Fund Revenue FY '21 - FY '22

FORECAST REVENUE GROWTH						
(\$ in Thousands)						
	FORECAST FY 2021	% CHANGE PRIOR YR	\$ CHANGE PRIOR YR	FORECAST FY 2022	% CHANGE PRIOR YR	\$ CHANGE PRIOR YR
Sales and Use	5,463,561.0	3.6%	191,102.9	5,694,341.3	4.2%	230,780.3
Income - Individual	5,272,682.3	4.0%	204,874.9	5,496,908.4	4.3%	224,226.0
- Corporate	376,152.3	2.9%	10,502.0	388,454.3	3.3%	12,302.0
Property	37,307.4	3.4%	1,212.9	36,845.6	-1.2%	(461.8)
Luxury - Tobacco	19,882.9	-2.8%	(562.5)	19,349.0	-2.7%	(533.8)
- Liquor	38,929.6	2.6%	978.3	39,937.8	2.6%	1,008.2
Insurance Premium	519,782.8	1.9%	9,757.3	526,476.2	1.3%	6,693.4
Other Taxes	14,272.1	5.7%	765.8	15,081.6	5.7%	809.5
Subtotal - Taxes	11,742,570.4	3.7%	418,631.6	12,217,394.1	4.0%	474,823.7
<b>Other Non-Tax Revenues:</b>						
Lottery	108,716.9	15.5%	14,603.5	115,999.3	6.7%	7,282.4
Licenses, Fees and Permits	36,095.0	2.7%	964.6	37,103.0	2.8%	1,008.0
Interest	47,118.5	11.2%	4,739.9	48,738.3	3.4%	1,619.9
Sales and Services	37,430.0	-1.9%	(733.7)	36,911.2	-1.4%	(518.8)
Other Miscellaneous	89,279.2	2.0%	1,790.7	91,892.3	2.9%	2,613.1
Transfers and Reimbursements	114,171.9	2.6%	2,927.2	117,002.9	2.5%	2,831.1
Disproportionate Share Revenue	83,012.9	-0.2%	(176.1)	82,937.4	-0.1%	(75.5)
Subtotal - Other Non-Tax	515,824.4	4.9%	24,116.0	530,584.5	2.9%	14,760.1
<b>Net On-Going Revenue</b>	<b>12,258,394.7</b>	<b>3.7%</b>	<b>442,747.5</b>	<b>12,747,978.6</b>	<b>4.0%</b>	<b>489,583.9</b>
Urban Revenue Sharing (URS)	(777,982.3)	N/A	(40,408.7)	(815,018.7)	N/A	(37,036.4)
<b>Net Ongoing Revenue w/ URS</b>	<b>11,480,412.4</b>	<b>3.6%</b>	<b>402,338.9</b>	<b>11,932,959.9</b>	<b>3.9%</b>	<b>452,547.5</b>
<b>One-Time Financing Sources:</b>						
Fund Transfers	0.0	-100.0%	(1,840.7)	0.0	N/A	0.0
Moody's Settlement Fund Transfer	0.0	N/A	0.0	0.0	N/A	0.0
Subtotal - One-Time Financing Sources	0.0	-100.0%	(1,840.7)	0.0	N/A	0.0
<b>Subtotal - Revenues</b>	<b>11,480,412.4</b>	<b>3.6%</b>	<b>400,498.2</b>	<b>11,932,959.9</b>	<b>3.9%</b>	<b>452,547.5</b>
Balance Forward		-100.0%	(824,804.0)		N/A	0.0
<b>Total - Resources</b>	<b>11,480,412.4</b>	<b>-3.6%</b>	<b>(424,305.8)</b>	<b>11,932,959.9</b>	<b>3.9%</b>	<b>452,547.5</b>

## Forecasted “Bottom-Line” ‘20 Revenue Growth is 2.8% - Adjusts Consensus Forecast for Transfers & URS

	'19	'20	'21	'22
Net Revenue Growth (6.0%/4.1%/3.7%/4.0%)	638	464	442	490
1-Time Fund Transfers	26	(99)	(2)	0
Urban Revenue Sharing	6	(63)	(40)	(37)
Total	670	302	400	453
% Change	6.6%	2.8%	3.6%	3.9%

Excludes Change in Beginning Balance

## Phase-In of \$83 M of Enacted Tax Reductions

	\$ in M*		
	<u>'20</u>	<u>'21</u>	<u>'22</u>
Corporate/IPT School Tuition Indexing	(18)	(21)	(26)
IPT Rate Reduction	(5)	(5)	(5)
Other	(3)	(1)	1
<b>Total</b>	<b>26</b>	<b>(27)</b>	<b>(30)</b>

- By '22, revenue base is \$(83) M lower than in '19
- Numbers are incorporated in Net Revenues estimates each year

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# **Tax Conformity Issues**



# Federal Tax Law Conformity

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- ❑ AZ taxable income largely conforms to federal definition, but no automatic link.
- ❑ State did not enact conformity to TY '18 changes during past legislative session.
- ❑ *If* state decides to conform for TY '18, JLBC speculatively projects a FY '19 gain of \$133 M.

# How Will Federal Tax Law Changes Affect AZ?

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- AZ uses income on the federal form as the starting point for our own individual and corporate income tax
- When feds change their income definition, AZ has to decide whether to conform in statute
- Conformity is not automatic – state needs to enact legislation

# When Are AZ and Federal Taxes Linked?

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## Linked

No

### Tax Rates

- Feds lowered both individual and corporate rates, but no AZ impact

### Deductions

Yes/No

- We do not conform to feds' standard & medical deductions
- AZ currently conforms to most others
- Feds have now reduced deductions, which would generate more state revenue

# Conformity Is Very Difficult to Estimate

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- ❑ Federal legislation includes over 100 provisions, is very complex and is the largest revision in the tax code in 30 years
- ❑ Some provisions can be estimated using AZ-specific data
- ❑ Most provisions, however, require prorating national data
  - Some national estimates are highly speculative
  - AZ's percent share of national estimates further adds to the speculation
- ❑ JLBC Staff's conformity projection is a \$133 M net gain in '19

# Main Conformity Provisions

- Assumes Current Delinking Continues

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	<u>\$ in M</u>
<input type="checkbox"/> Conform Itemized Deductions	138
- Eliminate 2% Business/Employee Expenses	
- Cap State & Local Taxes at \$10 K	
<input type="checkbox"/> Limit Pass-Through Losses to \$250k/\$500k	32
<input type="checkbox"/> Higher Bonus Depreciation/Business Expensing	(47)
<input type="checkbox"/> Expand Simplified Cash Accounting	(24)
<input type="checkbox"/> Limit Interest Expense Deduction to 30% of Earnings	17
<input type="checkbox"/> Net of All Other	17
Total	<u>133</u>

# Key Conformity Assumptions

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- ❑ Continue any current “delinking”
  - Medical expenses
  - Limit bonus depreciation to individual filers. Expanding to corporate filers costs \$68 M
  - No taxation of foreign profits
  
- ❑ Discount estimates for safety factor
  - 25% on any prorated federal estimates
  - 10% on DOR model runs (itemized deduction calculations)

## South Dakota v. Wayfair Implications for AZ

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- ❑ In recent *South Dakota v. Wayfair Inc.* ruling, Supreme Court overturned physical presence (nexus) requirement.
- ❑ *Wayfair* cleared the way for states to start collecting sales tax from out-of-state sellers.
- ❑ However, *Wayfair* ruling suggests that states set a minimum collection threshold and provide a uniform, simplified tax structure.
- ❑ Federal report suggests that GF could gain \$85 M.