
FY 2017 JLBC Baseline

Full Version

January 15, 2016

JLBC

Summary of Current Budget Status

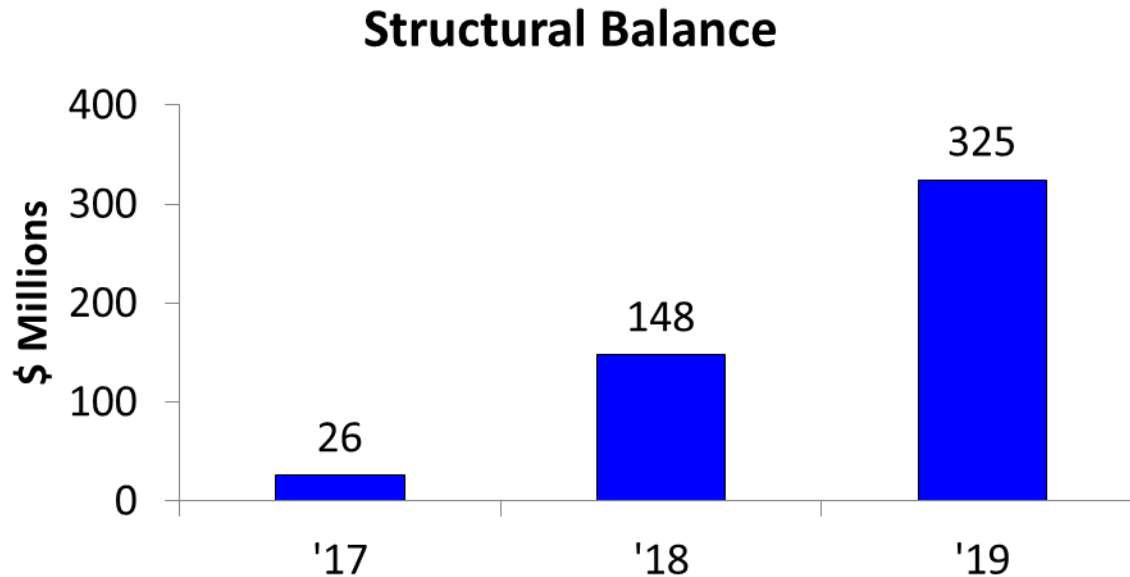
- ❑ The Baseline compares the 4-sector consensus revenue forecast with cost of current funding formulas through '19
- ❑ '17 Baseline has a large cash balance of \$625 M, primarily due to \$600 M in one-time revenues
- ❑ Permanent revenues only exceed permanent spending by \$26 M (the structural balance) for '17
- ❑ Baseline structural balance grows to \$325 M by '19
 - But only if no discretionary changes for 3 years

'17 Challenge: Avoid Re-creating a Structural Gap

- ❑ '17: large cash balance, small structural balance
- ❑ Using cash balance for ongoing initiatives re-creates structural gap in '18
- ❑ Excludes \$460 M Rainy Day Fund Balance

| FY 2017 Baseline Projection | |
|-----------------------------|----------------|
| | \$ in M |
| Balance Forward / Other | \$ 599 |
| One-time Revenues | |
| Ongoing Revenues | 9,397 |
| Ongoing Spending | (9,371) |
| Cash Balance | \$ 625 |

Baseline Structural Balance Improves Through '19



- ❑ Improving balances could provide more flexibility, but...
- ❑ Based on highly unlikely assumption of no discretionary changes in next 3 years

Fiscal Policy: Improvements, but Significant Challenges Ahead

- ❑ Credit rating raised in '15 to AA/Aa2, 3rd highest level
 - 26 states have higher ratings
 - Rating agencies linked upgrade to improved structural balance

- ❑ State still lacks statutory policy for addressing one-time monies
 - Capital gains and Corporate Income Tax are volatile revenue streams
 - JLBC Staff continues to recommend diverting one-time monies to one-time purposes
 - 2014 California ballot initiative channels some one-time monies into their Rainy Day Fund (Appendix A)

FY '17 – Potential Candidates for One-time Monies

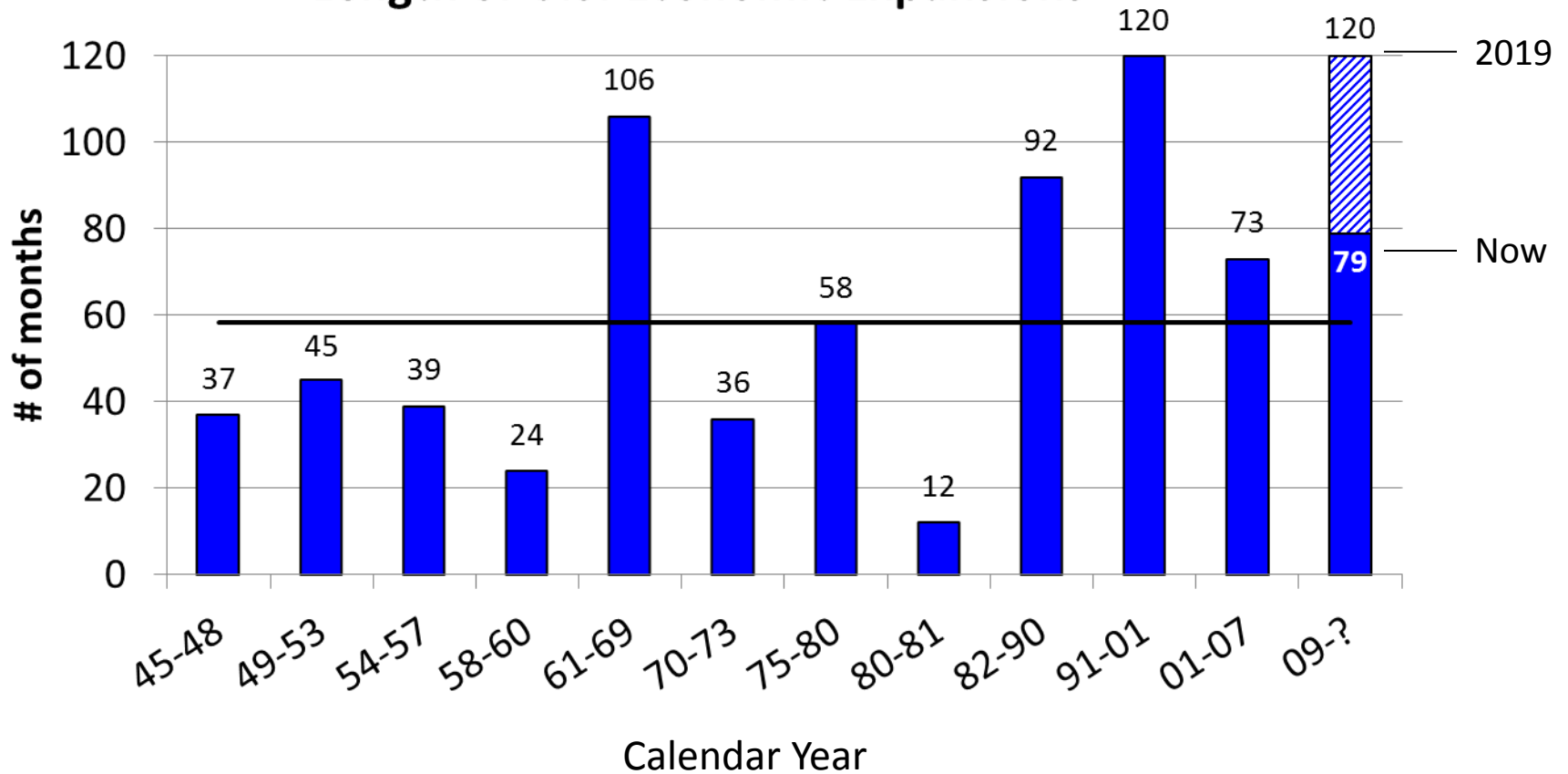
- Rollover Payoff
 - State has \$1.2 B in “rollovers,” which reflect deferral of current year expenses to next fiscal year
- Information Technology Initiatives
 - Examples: DOR and DCS IT systems
- Infrastructure
 - Supplement HURF with General Fund monies
 - Other Capital Improvement projects
- Pay down Operating Debt Buyback - \$84 M annual payment

JLBC Staff Recommended Improvements

- JLBC review of DCS line item transfers would permit further legislative input on moving in-home service funding to out-of-home placements
- Revamp November 2016 ballot referral on the use of the Permanent Fund for Land Department administrative expenses to increase legislative oversight and reduce potential beneficiary impact
- Clarify the 2015 law regarding state and local responsibilities regarding the 1% homeowner property tax cap
- Appropriate all or none of University tuition, thereby eliminating current hybrid process
- Improve knowledge of Corporate Income Tax by requiring DOR to publish more timely data on use of credits

Forecast Risk: Current Expansion Exceeds Historical Average

Length of U.S. Economic Expansions



Forecast Risks II

- 1% Variance Yields \$625 M Over 3 Years

Potential Gains

- National recovery creating more interstate migration

Potential Gain or Loss

- Estimate of ongoing '15 Capital Gains and Corporate collections

Potential Litigation Losses

- Ongoing retirement litigation
- Hospital assessment
- Rental car surcharge
- Foster care lawsuit in U.S. District Court

Revenue Overview

AZ Economy is Growing, But Slower than Average

- Given Our Size, Historical Norm May Not be Realistic

Key Indicators

| | <u>Historical</u> | <u>Current</u> |
|---|-------------------|----------------|
| Overall Job Growth | 3.9% | 2.5% |
| Construction Employment | 5.7% | 5.5% |
| Population Growth | 3.1% | 1.5% |
| Single Family Residential Building Permits | 38K | 22K |

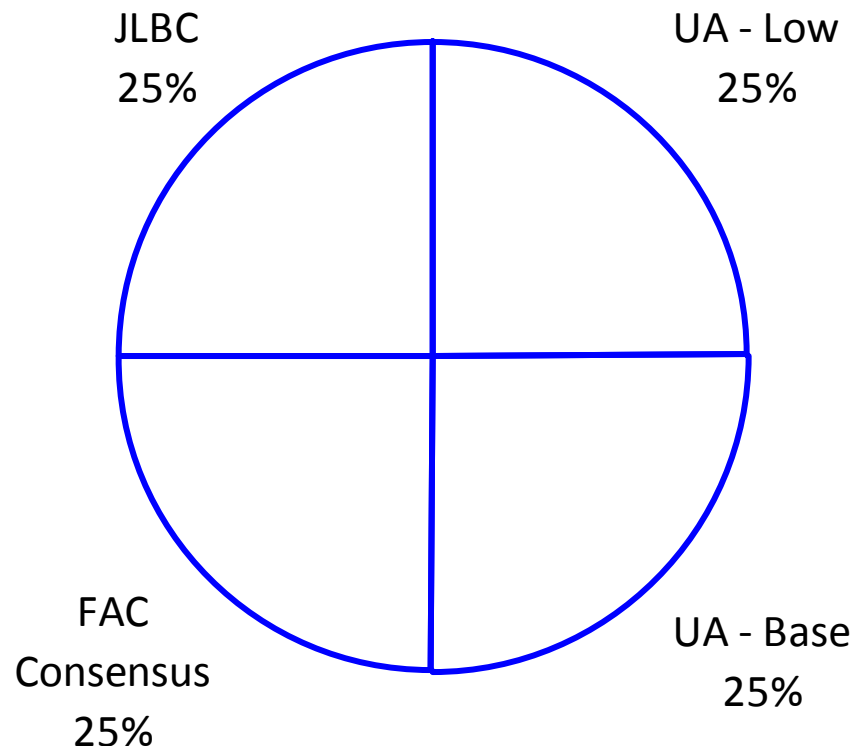
- ❑ Overall job and population growth remain significantly below historical standard
- ❑ Construction employment has picked up but still remains 115,000 workers behind the 250,000 (June 2006) peak
- ❑ Number of annual building permits has grown substantially—from 17k last year to 22k now

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:

- Finance Advisory Committee
- UA model – base
- UA model – low
- JLBC Staff forecast
- Remaining revenues (10%) are JLBC Staff forecast



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

Revenue Growth Improves Slightly Over Time

January Consensus Forecast

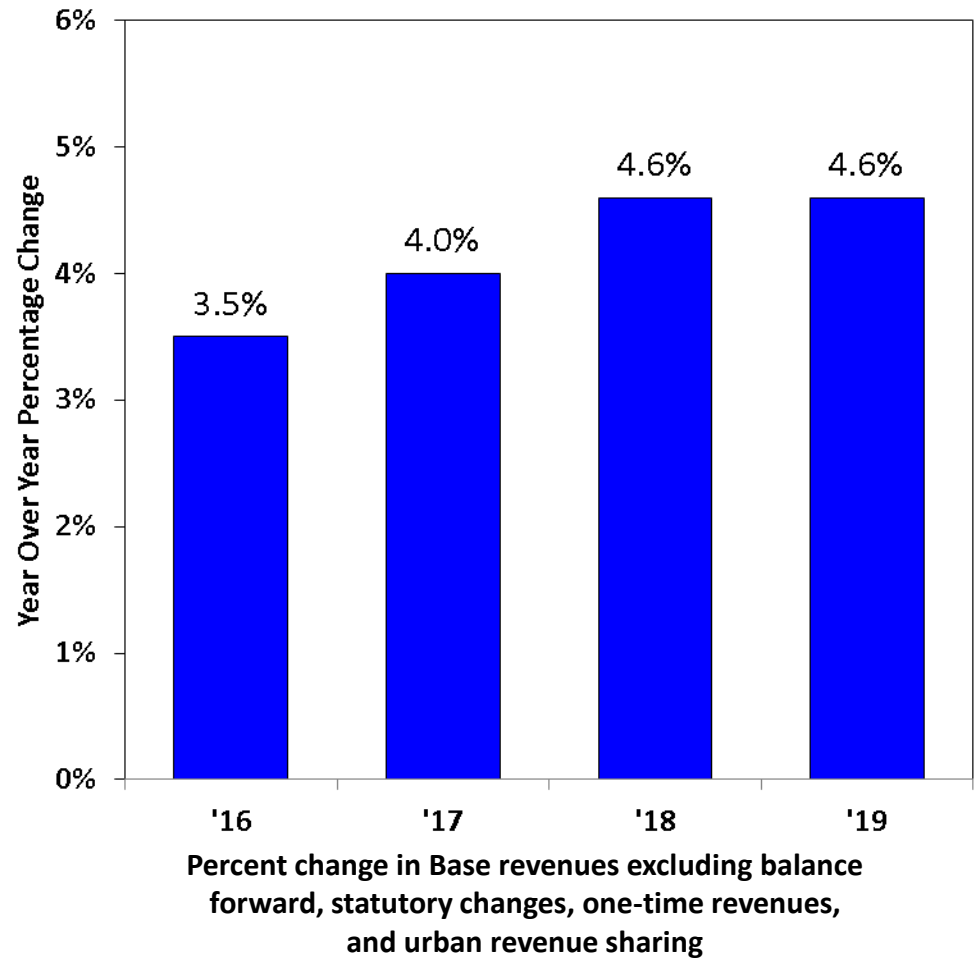
- Finance Advisory Committee
- UA model – base
- UA model – low
- JLBC Staff

Chance of Exceeding Forecast

- 66%

Long Run Average Growth

- 4.7%



Is the FY '16 Growth Rate Reasonable?

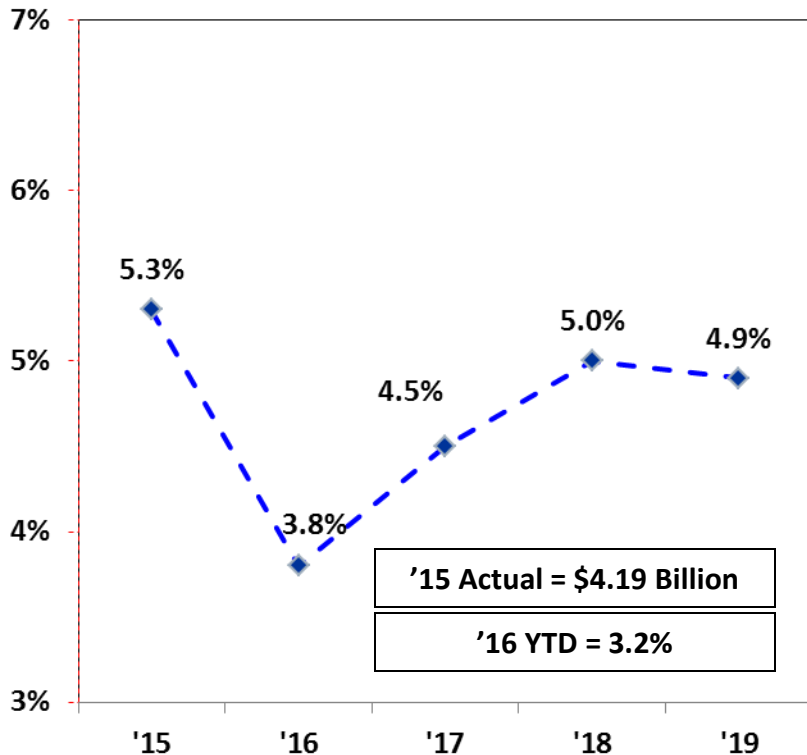
- ❑ After adjusting for tax laws and one-time funds, the projected '16 growth rate is 3.0%
 - The comparable preliminary growth rate through December is also 3.0%
 - “Core” Revenues – sales tax (2.5%) and withholding (2.8%)

- ❑ The Baseline would increase the forecast of these ongoing revenues by \$341 M above the enacted budget
 - Through a preliminary December estimate, '16 revenues are \$209 million above the enacted budget

- ❑ The 2nd half forecast gain is expected to slow due to the higher collection level in the 2nd half of '15
 - There is uncertainty regarding the sustainability of last year's capital gains collections

Sales Tax

- Projected Growth of 3.8% in '16 and 4.5% in '17



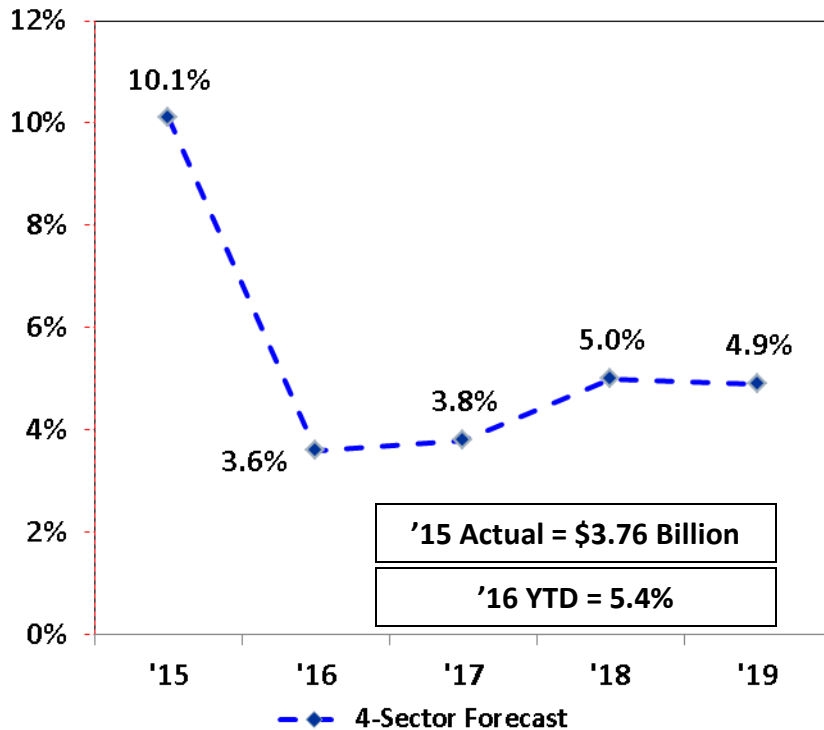
—◆— 4-Sector Forecast

Percent Change in Base Revenue Excluding Statutory Changes

- Since 1/15, retail is up 10%; contracting is down (17)%
- Trends likely related to Jan. '15 contracting law
- \$15 M in '16 amnesty collections
- Overall, 2.5% 1st Half was weak (adjusted for amnesty)

Individual Income Tax

- Projected Growth of 3.6% in '16 and 3.8% in '17



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

- ❑ '15: low withholding growth offset by capital gains
- ❑ That trend persists in 1st half of '16
- ❑ Capital gains are volatile and may not be sustainable
- ❑ 4.8% 1st Half growth (excluding \$11 M in '16 amnesty)

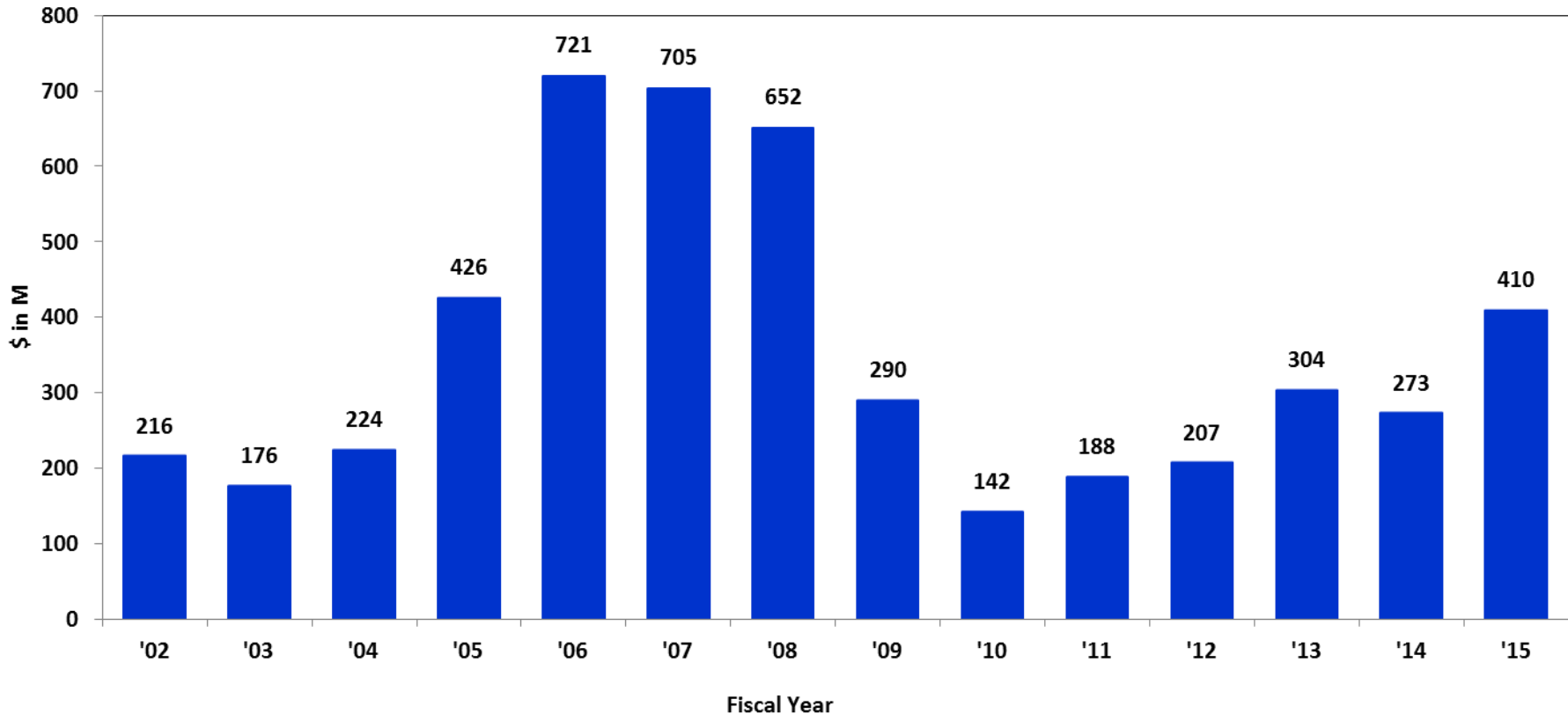
'16 So Far Continues Slow Withholding/High Payments

| Percent Gain Above Prior Year | | |
|-------------------------------|-------------|--------------------------------|
| | <u>'15</u> | <u>1st Half '16</u> |
| Withholding | 3.4% | 2.8% |
| Payments | 14.8% | 19.0% |
| Refunds | (0.8)% | 11.1% |
| Net | <u>8.6%</u> | <u>4.8%</u> |

- ❑ Withholding growth in the 1st Half is sluggish at 2.8%
- ❑ Annual withholding growth has not been above 3.5% since '11
- ❑ Payments up 19.0% in 1st Half of '16 – carryover impact of TY '15 filings
- ❑ Little refund activity occurs until tax season

Volatility of Capital Gains Complicate Forecasting

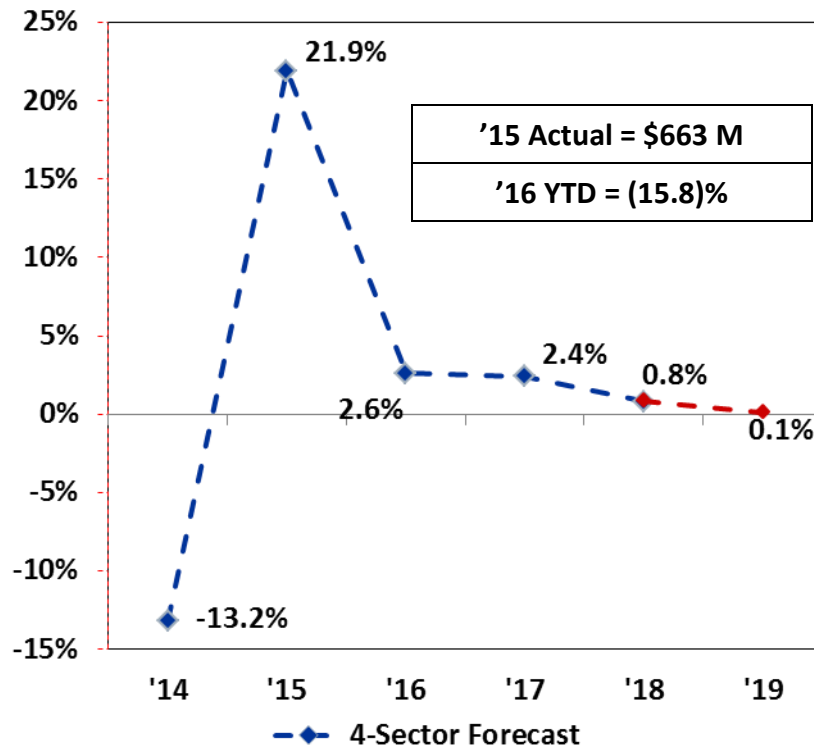
- Final '15 Capital Gain Receipts to be Determined



Individual Income Tax Capital Gains Revenue

Corporate Income Tax

- Projected Growth of 2.6% in '16 and 2.4% in '17

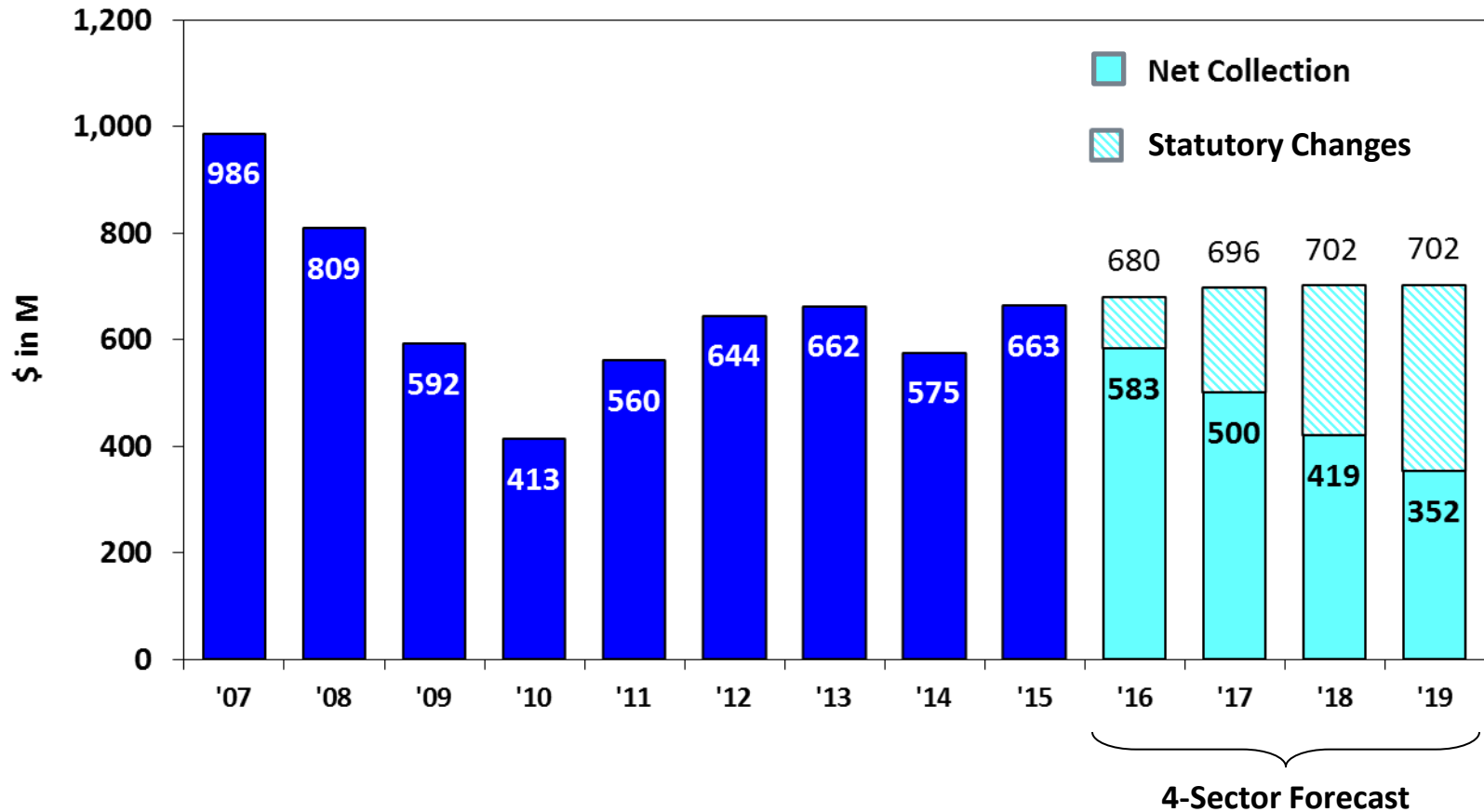


Percent Change in Base Revenue Excluding Statutory Changes and One-Time Changes

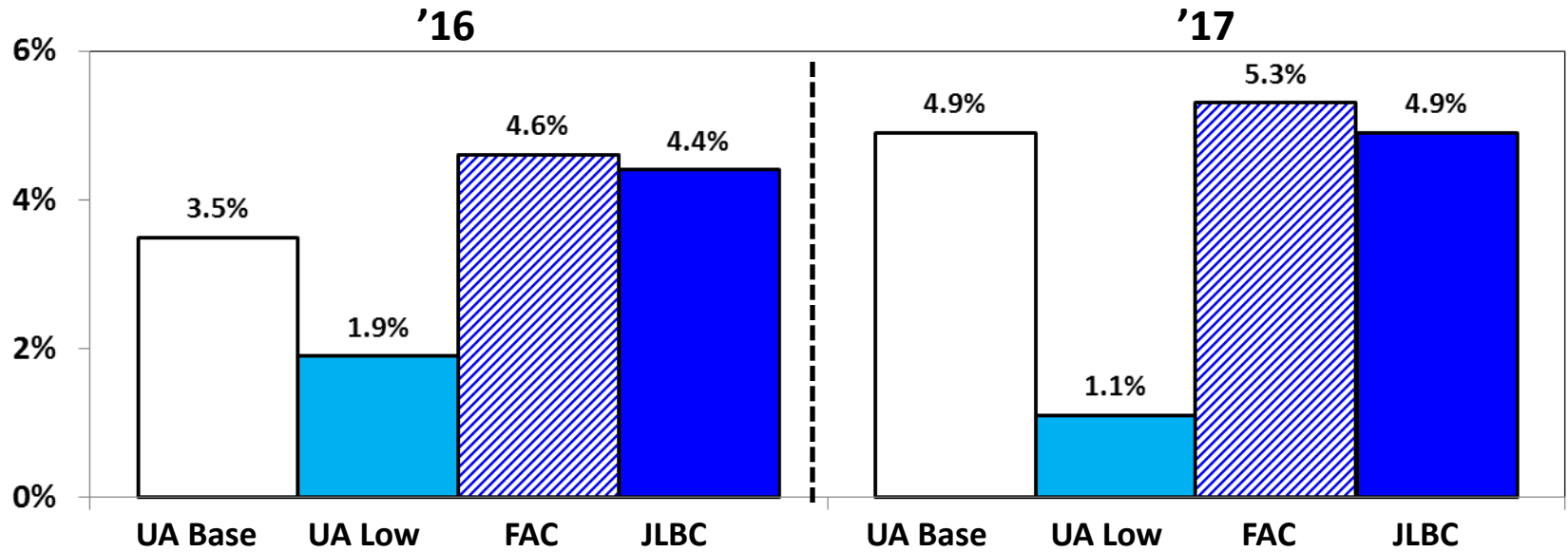
- In 22 of last 28 years, annual change has been > +/- 10%
- '14 & '15 results inexplicable
- 4-year tax cut was to begin in '15, likely delayed to '16
- (22.3)% 1st Half decline (excluding \$21 M in '16 amnesty)

'19 CIT Projected to be \$352 M

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



4-Sector Base Growth is 3.5% in '16 & 4.0% in '17



- ❑ With exception of UA Low, 3 other sectors have comparable growth rates
- ❑ Recessions rarely predicted in advance
- ❑ Especially given current length of expansion, an economic slowdown remains possible

Phase-In of \$261 M of Enacted Tax Reductions

| | \$ in M* | | |
|--|-------------|-------------|-------------|
| | <u>'17</u> | <u>'18</u> | <u>'19</u> |
| <input type="checkbox"/> Corporate Rate Reduction/Sales Factor | (77) | (74) | (52) |
| <input type="checkbox"/> Corporate School Tuition Indexing | (10) | (12) | (15) |
| <input type="checkbox"/> Other | (11) | (4) | (6) |
| Total | <u>(98)</u> | <u>(90)</u> | <u>(73)</u> |

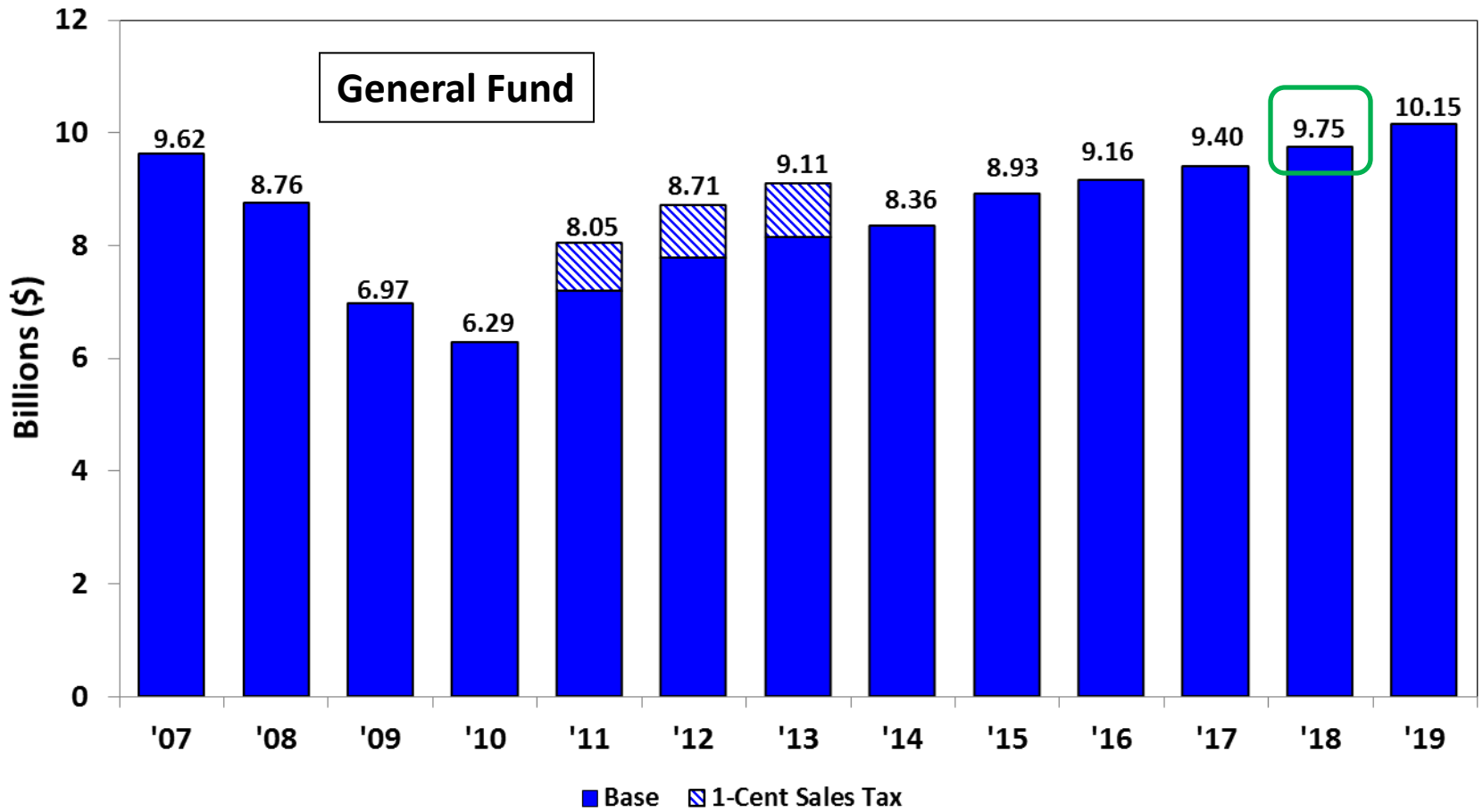
* Represents changes to prior year. By '19, revenue base is \$(261) M lower than in '16.

Components of the Revenue Forecast

- Excludes Change in Beginning Balance

| | \$ in M | | | |
|---|-------------|-------------|-------------|-------------|
| | <u>'16</u> | <u>'17</u> | <u>'18</u> | <u>'19</u> |
| Base Revenue Growth (3.5%/4.0%/4.6%/4.6%) | 333 | 389 | 461 | 475 |
| One-Time Fund Transfers | 139 | (117) | (100) | 0 |
| One-Time Amnesty Collections | 47 | (47) | 0 | 0 |
| Previously Enacted Tax Legislation | (98) | (98) | (90) | (73) |
| Urban Revenue Sharing | 3 | (58) | (13) | (6) |
| Total | 424 | 69 | 258 | 396 |
| % Change | 4.7% | 0.7% | 2.7% | 4.1% |

Revenue Will Reach Pre-Recession Level in '18



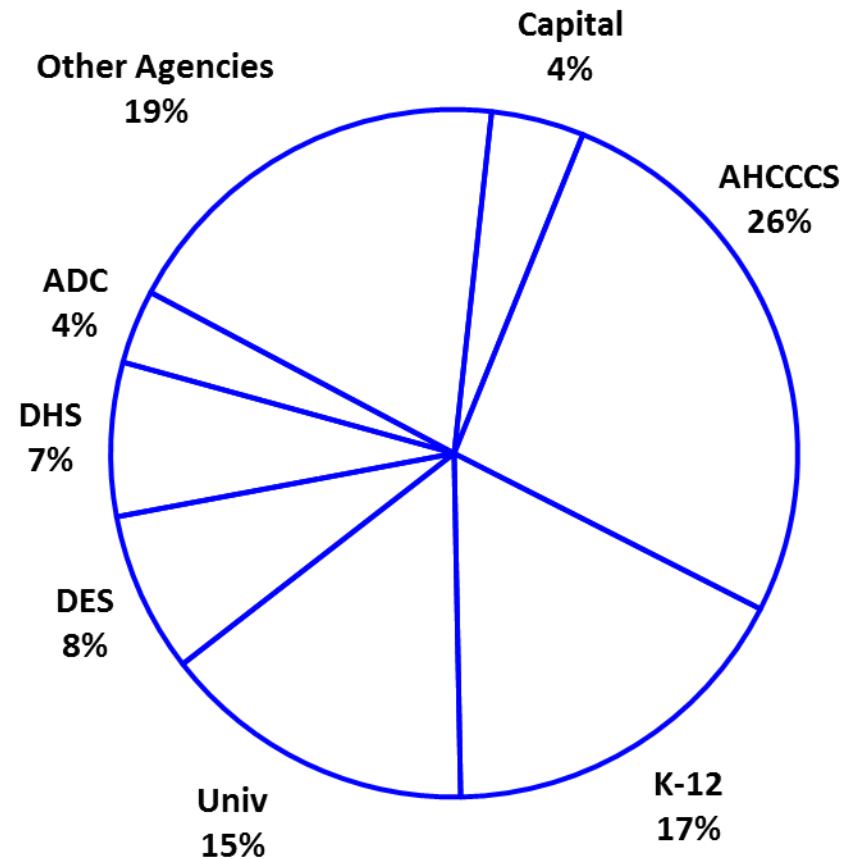
Excludes balance forward and other one-time revenues. Includes tax law changes and Urban Revenue Sharing.

Spending Overview

'16 Total Spending is \$32.7 Billion

- General and Non-General Fund

| <u>Budget Unit</u> | <u>\$ in Millions</u> |
|--------------------|-----------------------|
| AHCCCS | 8,610.6 |
| Education (K-12) | 5,623.7 |
| Universities | 4,833.7 |
| Economic Security | 2,463.6 |
| Health Services | 2,361.5 |
| Corrections | 1,136.7 |
| Other Agencies | 6,201.4 |
| Capital | 1,426.4 |
| TOTAL | 32,657.6 |



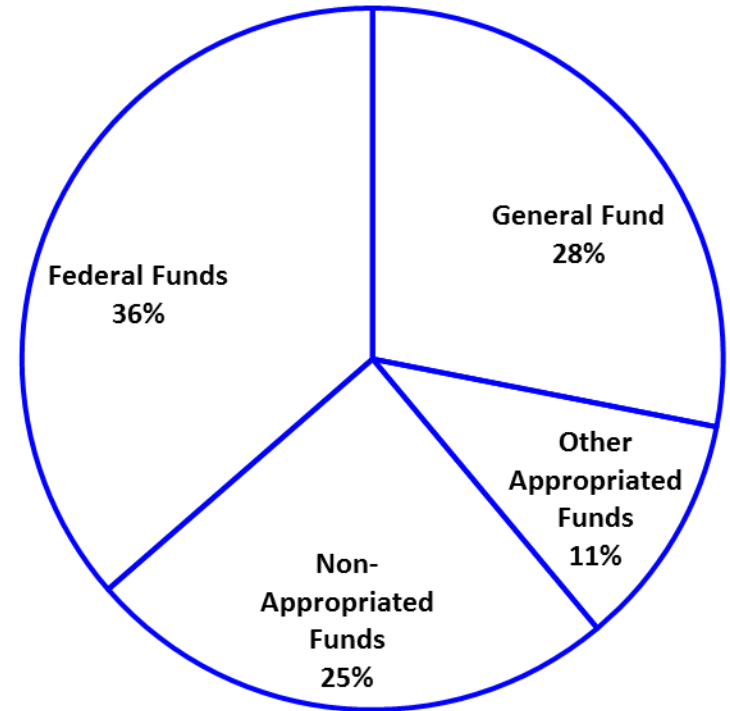
The \$9.2 B General Fund Share is 28% of Total Funds

- GF Share Down from 43% in '02

'16 Enacted

\$ in Millions

| | |
|--------------------------|-------------------|
| General Fund | 9,175.6 |
| Other Appropriated Funds | 3,537.2 |
| Non-Appropriated Funds | 8,056.2 |
| Federal Funds | 11,888.6 |
| TOTAL | \$32,657.6 |



'17 – '19 Baseline Spending Projections

- ❑ Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- ❑ '17 total baseline spending estimated at \$9.4 B
- ❑ Continues annual suspension of \$490 M of inactive formulas
- ❑ Continues \$1.2 B in “rollover” payments

Projected Baseline Spending Changes

| | GF \$ in M Above Prior Year | | |
|---------------------------------------|-----------------------------|----------------|----------------|
| | '17 | '18 | '19 |
| K-12 | 84 | 138 | 124 |
| AHCCCS | 79 | 77 | 98 |
| DCS | (9) | 0 | 0 |
| DES | 24 | 25 | 29 |
| Corrections | 23 | 7 | 0 |
| Universities | 12 | 4 | 0 |
| Employee Health Insurance | (8) | 0 | 0 |
| Land Dept. Self-Fund | 0 | (13) | 0 |
| Other | (24) | (2) | (32) |
| Total Operating Budget Changes | 181 | 236 | 219 |
| Total Spending | \$9,371 | \$9,607 | \$9,826 |
| % Change | 1.4% | 2.5% | 2.3% |

Main Caseload Assumptions

- ❑ K-12 projected to grow by \$84 M
 - 1.6% inflation/1.4% student growth/property tax cut
 - (\$61) M in savings for previously enacted JTED and declining enrollment provisions

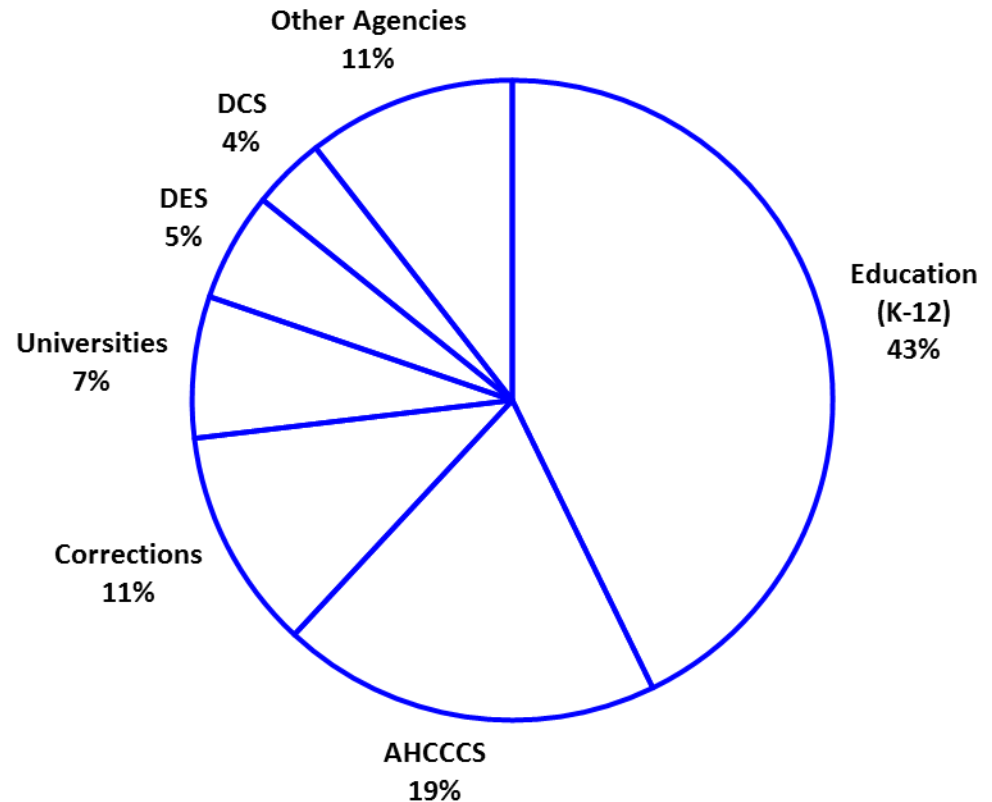
- ❑ Medicaid '17 spending grows 4.4%
 - 2.5% caseload, 1.5% capitation, and better federal match rates

- ❑ DCS funding adjusted down consistent with May 2014 plan
 - Reflects one-time backlog funding, but problem remains the same

- ❑ ADC reflects cost for opening 1,000 previously authorized beds

'17 General Fund Baseline by Agency

| <u>Budget Unit</u> | <u>\$ in Millions</u> |
|-----------------------|-----------------------|
| Education (K-12) | 4,026.0 |
| AHCCCS | 1,801.1 |
| Corrections | 1,052.5 |
| Universities | 672.9 |
| Economic Security | 520.0 |
| Child Safety | 347.7 |
| Other Agencies | 990.7 |
| Net Revertments | (40.0) |
| Total Spending | 9,370.9 |



K-12 Estimated Baseline Changes for '17

- Assumes Passage of Prop 123

| | GF \$ in M Above Prior Year | | |
|--|-----------------------------|------------|------------|
| | '17 | '18 | '19 |
| Enrollment Growth (1.4% for all years) | 84 | 85 | 86 |
| Higher Average Cost per Pupil | 20 | 20 | 20 |
| Inflation (1.14%, 1.90%, 1.84%) | 65 | 100 | 105 |
| Property Taxes from New Construction | (38) | (43) | (46) |
| Business Property Tax Reduction | 26 | 0 | 0 |
| Eliminate Declining Enrollment Hold Harmless | (31) | 0 | 0 |
| JTED/District Funding | (30) | 0 | 0 |
| Other | (12) | (24) | (41) |
| Total | 84 | 138 | 124 |

2015 Special Session & Proposition 123

Increases Funding to Schools & Other Public Institutions

- Increases the distribution rate of the State Land Trust Permanent Fund from 2.5% to 6.9% from '16 - '25, conditional upon voter approval in May 2016
 - Distributions to K-12 would rise from \$87 M to \$259 M in '16
 - Provides \$3.5 billion in K-12 state aid over 10 years
 - Non-K-12 institutions would receive an additional \$12 M in '16

- Resolves K-12 inflation lawsuit

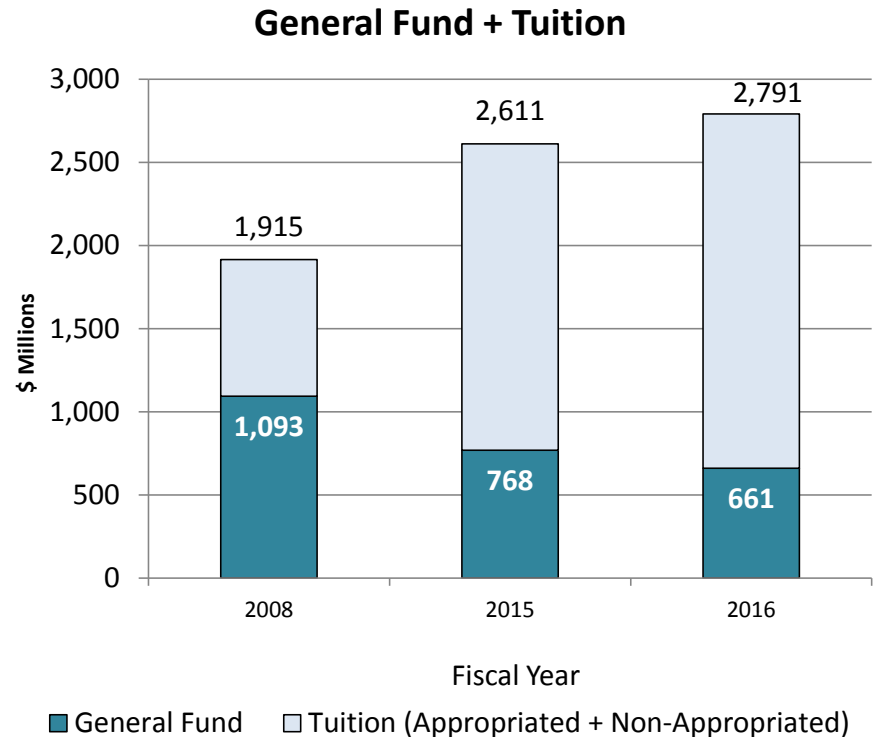
- Enacts trigger mechanisms to suspend inflation adjustments and higher land trust distribution rate during adverse economic conditions and limit K-12 expenditures as % of General Fund

University Baseline Spending Increases by \$12 M

- ❑ 3-year '16 budget plan added \$8 M in '17
- ❑ Restore \$4 M in one-time debt refinance savings
- ❑ Technical Correction on Health Insurance

University General Fund Reduction Since '08 Offset by Tuition Increases

- ❑ Total tuition increased from \$822 M to \$2.1 B
- ❑ Total General Fund + Tuition grew from \$1.9 B to \$2.8 B
- ❑ '08-'16 spending per student grew from \$17.4 K to \$18.4 K



Medicaid Agencies Baseline Spending Changes

| | GF \$ in M Above Prior Year | | |
|-----------------|-----------------------------|-------------|-------------|
| | '17 | '18 | '19 |
| AHCCCS | 597 | 77 | 98 |
| DHS | (517) | 0 | 0 |
| DES | 24 | 25 | 29 |
| Total | 104 | 103 | 127 |
| % Growth | 4.4% | 4.3% | 5.0% |

- ❑ DHS Behavioral Health transferred to AHCCCS in '17
- ❑ AHCCCS base enrollment growth of 2.5%; DD growth of 4.5%
- ❑ As required by '16 budget, capitation limited to 1.5% in '17 and '18
- ❑ Higher federal match rate generates some offsetting savings

AHCCCS Caseloads

-Since Coverage Expansion in CY '14, Enrollment Increased 544 K

| <u>Population</u> | Enrollment (Thousands) | | |
|-------------------|---------------------------|------------------------|---------------|
| | December <u>2013</u> | January <u>2016</u> | <u>Change</u> |
| Traditional | 880 | 1,053 | 173 |
| Childless Adults | 68 | 306 | 238 |
| Adult Expansion | - | 80 | 80 |
| All Others | <u>310</u> | <u>363</u> | <u>53</u> |
| TOTAL | 1,258 | 1,802 | 544 |

DCS Baseline Spending Estimates

- Plus \$5 M in ADOA for DCS Automation

| | GF in \$ in M Above Prior Year | | |
|----------------------------------|--------------------------------|----------|----------|
| | '17 | '18 | '19 |
| One-Time Backlog | (12.4) | 0 | 0 |
| Preventive Services | 4 | 0 | 0 |
| ICAC transfer to AG | (0.4) | 0 | 0 |
| Total Additional Spending | (8.8) | 0 | 0 |

- ❑ “Backlog” refers to cases that have had no action in 60 days
- ❑ '17 estimates consistent with May 2014 Special Session plan, which assumed elimination of backlog by June 2017
- ❑ Since May 2014, however, backlog has increased

Department of Corrections Baseline Spending Changes

| | GF \$ in M Above Prior Year |
|--|-----------------------------|
| | <u>'17</u> |
| Open 1,000 new private beds in September '16 | 17.6 |
| Inmate health care vendor adjustment | 5.1 |
| Employer retirement rate increase | 0.7 |
| Other | <u>(0.9)</u> |
| Total | 22.6 |

Small ADC Bed Surplus with Use of Temporary Beds

| June 2017 Total Male Bed (Shortfall)/Surplus | | |
|---|-----------------|-----------------|
| <u>Classification</u> | | |
| <u>Level</u> | <u>June '16</u> | <u>June '17</u> |
| Minimum | 368 | 296 |
| Medium | (223) | (99) |
| Close | (106) | 158 |
| Maximum | 149 | 89 |
| Total | 188 | 444 |

- ❑ Prison population projected to grow by 744 male inmates in '17
- ❑ Includes more than 5,700 temporary beds

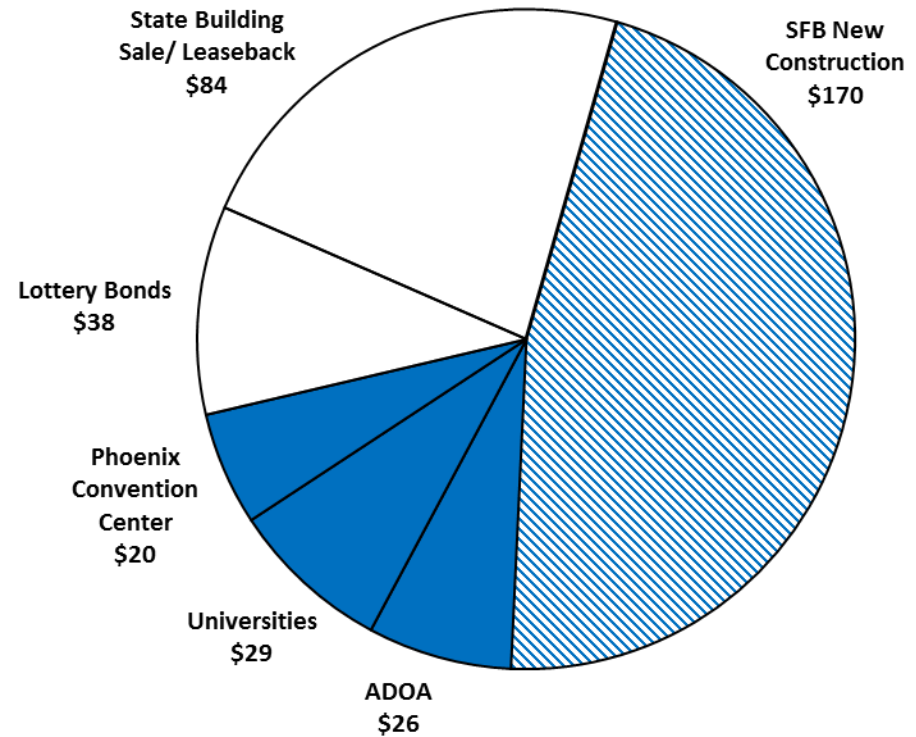
General Fund Debt Service Cost \$367 M

- Would Represent 6th Largest Budget Unit

Annual Payments

| | | |
|---|-------------------------|----------|
| ■ | Capital Facilities/Uses | \$ 75 M |
| ▨ | School Facilities Board | \$ 170 M |
| □ | Operating | \$ 122 M |

\$ in Millions



'17 General Fund = \$367 M

Includes \$38 M Lottery Bonds

State Employer Retirement Impacts

- '17 General Fund Cost is \$178 M; Total State Cost is \$499 M

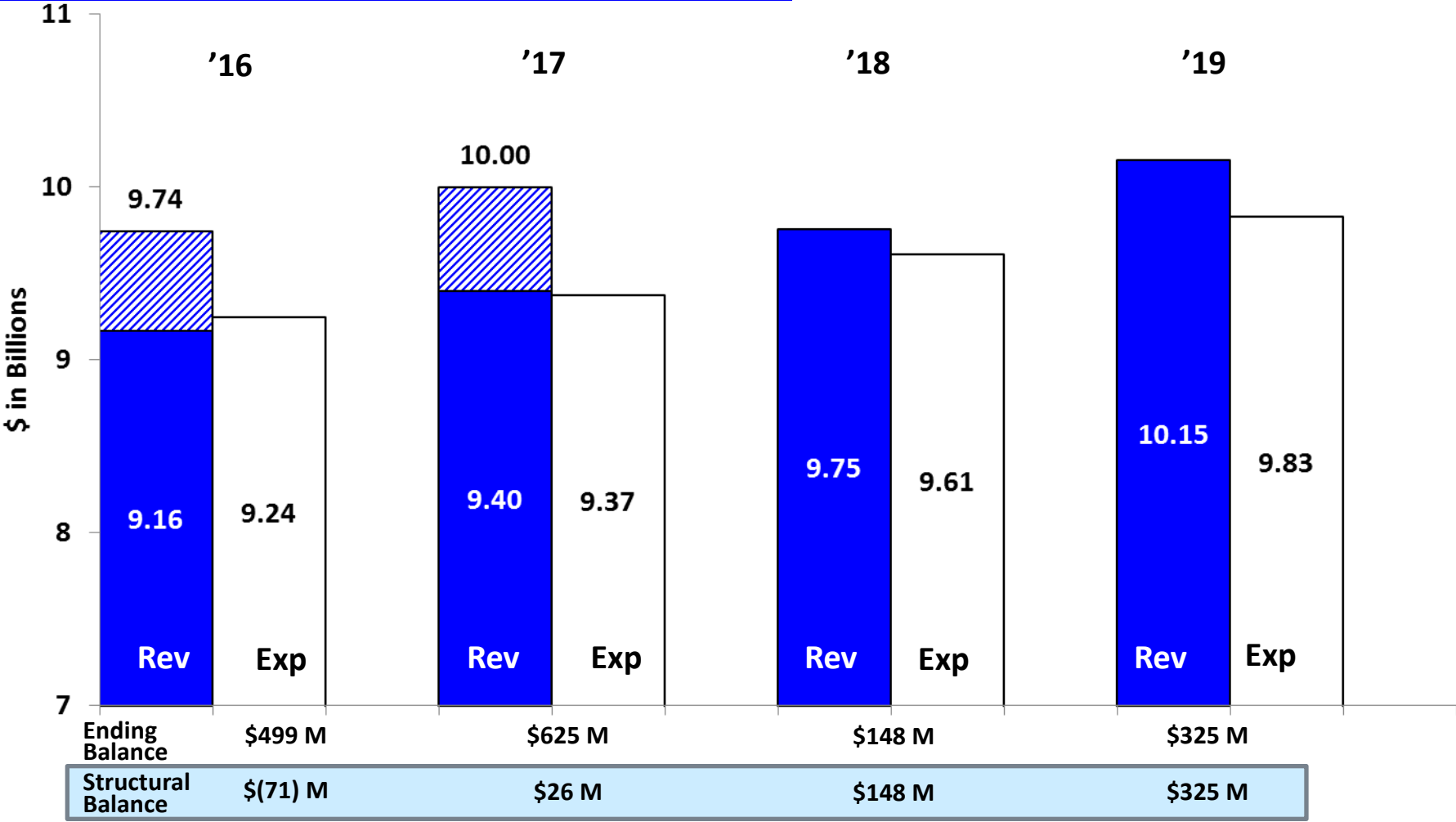
- ❑ Higher Employer rates will cost \$3.1 M in '17, including \$1.4 M from General Fund
- ❑ In line with '16 budget's 3-year plan, Baseline only funds Corrections' \$0.7 M increase

| Employer Rates | Funded Status | Employer '16 Rate | Employer '17 Rate | '17 Cost Increase |
|-----------------------|----------------------|--------------------------|--------------------------|--------------------------|
| ASRS | 77% | 11.47% | 11.48% | \$245,800 |
| PSPRS* | 49% | 41.37% | 42.61% | \$1,864,200 |
| CORP* | 57% | 18.25% | 18.71% | \$959,500 |
| EORP | 39% | 23.50% | 23.50% | 0 |

*The contribution rates for PSPRS and CORP subgroups are aggregated.

Projected Ending Balance Estimates

Projected General Fund Revenues & Expenditures



■ Base Revenue
 ▨ Cash Balance / One-Time
 Ongoing Expenditures

FY 2017 projected ending balance assumed to be allocated
 as part of the budget process



**STAFF OF THE
JOINT LEGISLATIVE BUDGET COMMITTEE**

| | |
|---|------------------|
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| Administrative Assistant / JLBC & JCCR Clerk..... | Kristy Paddack |

Appendices

Appendix A: California Initiative Addresses Volatility

- Provides Possible Template to Stabilize AZ Finances

- 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

Appendix B: Other JLBC Suggested Fiscal Policy Improvements

- Require AHCCCS to report on the availability of inpatient children psychiatric beds in Arizona in light of the transfer of some children out of state
- Revisit School Facilities Board provision which allows districts to exclude certain locally funded space when determining if the state should build a new school
- In light of University proposal to convert their performance funding model into a General Fund amount per resident student, review other possible options
- Increase transparency of Retirement Systems' private equity fees without hindering investment performance

Appendix C: January 2016 4-Sector Forecast

| | <u>2016</u> | <u>2017</u> | <u>2018</u> | <u>2019</u> |
|------------------------------|-------------|-------------|-------------|-------------|
| Sales Tax | | | | |
| JLBC Forecast | 4.0% | 4.6% | 4.5% | 4.3% |
| UA – Low | 3.0% | 2.6% | 4.7% | 4.9% |
| UA – Base | 4.0% | 5.6% | 6.0% | 6.0% |
| FAC | 4.1% | 5.2% | 4.8% | 4.3% |
| Average: | 3.8% | 4.5% | 5.0% | 4.9% |
| Individual Income Tax | | | | |
| JLBC Forecast | 4.6% | 5.3% | 4.5% | 4.5% |
| UA – Low | 1.9% | -0.1% | 4.6% | 5.2% |
| UA – Base | 2.5% | 4.6% | 5.5% | 5.7% |
| FAC | 5.2% | 5.4% | 5.2% | 4.4% |
| Average: | 3.6% | 3.8% | 5.0% | 4.9% |
| Corporate Income Tax | | | | |
| JLBC Forecast | 5.4% | 4.4% | 4.2% | 4.0% |
| UA – Low | -4.6% | -2.8% | -5.5% | -4.1% |
| UA – Base | 5.4% | 1.9% | -1.7% | -5.5% |
| FAC | 4.1% | 5.5% | 4.8% | 3.9% |
| Average: | 2.6% | 2.4% | 0.8% | 0.1% |

| | | | | |
|---------------------------------------|-------------|-------------|-------------|-------------|
| JLBC Weighted Average | 4.4% | 4.9% | 4.5% | 4.4% |
| UA Low Weighted Average | 1.9% | 1.1% | 4.2% | 4.7% |
| UA Base Weighted Average | 3.5% | 4.9% | 5.3% | 5.4% |
| FAC Consensus Weighted Average | 4.6% | 5.3% | 5.0% | 4.3% |
| “Big-3” Weighted Average | 3.6% | 4.1% | 4.7% | 4.7% |
| Consensus Weighted Average* | 3.5% | 4.0% | 4.6% | 4.6% |
| Adjusted Consensus Weighted Average** | 2.5% | 3.0% | 3.7% | 3.9% |

* Represents on-going revenue adjusted for small revenue categories.

** Represents on-going revenue adjusted for tax law changes; excludes Urban Revenue Sharing.