

FY 2017 BASELINE SUMMARY

Overview

The FY 2017 Baseline provides an estimate of the state's General Fund balances. The revenue projections reflect a consensus economic forecast while the spending estimates represent active funding formula requirements and other obligations. The Baseline does not represent a budget proposal, but an estimate of available resources after statutory requirements.

A.R.S. § 35-125 requires that the General Appropriation Act annually delineate the revenue and expenditure projections for 3 years. The budget, however, would only provide actual appropriations for FY 2017.

In terms of the budget outlook:

- Total FY 2017 General Fund revenue is projected to be \$10.0 billion. Revenues would be \$256 million more than in FY 2016. Prior to tax law changes and other adjustments, the 4-sector consensus base revenues are forecast to grow by \$389 million, or 4.0%. Including all tax law changes and other adjustments, revenues would grow from \$9.74 billion to \$10.0 billion, or 2.6%.
- In comparison, FY 2017 spending is projected to be \$9.37 billion. This amount reflects \$130 million, or 1.4%, growth in expenditures, which is limited to current funding formulas and previously-enacted adjustments. K-12 growth of \$84 million and Medicaid growth of \$79 million are offset by declines in one-time information technology, capital, Department of Child Safety (DCS) spending, and technical adjustments for administrative adjustments and revertsments.
- The projected FY 2017 ending balance is \$625 million. Assuming that the \$625 million balance is allocated in the FY 2017 process, the balance would be \$148 million in FY 2018 and \$325 million in FY 2019.
- The Baseline assumes passage of Proposition 123 at the May 2016 Special Election, which would have a total fiscal impact of \$299 million in FY 2016. The funding would be generated from increasing the State Land Trust distribution rate from 2.5% to 6.9% per year (\$172 million), adding \$52 million in new General Fund monies and incorporating \$74.4 million of formerly separate "Additional Inflation" monies into Basic State Aid. The Proposition's 10-year impact would be \$3.5 billion.
- These cash balance estimates do not include \$460 million in the state's Rainy Day reserve (Budget Stabilization Fund).

FY 2016

The FY 2016 ending balance is currently projected to be \$499 million, an increase of \$535 million from the original budget estimate of a \$(35) million shortfall. Total revenues, including the beginning balance, are forecast to be \$9.74 billion compared to spending of \$9.24 billion. The \$535 million adjustment has 4 components:

- An increase of \$312 million in ongoing revenues under the updated January consensus forecast, the result of higher-than-budgeted FY 2015 revenues offset by a slightly lower base revenue growth rate of 3.5% (down from 3.8%).
- An increase of \$29 million in estimated one-time financing sources, primarily due to higher-than-projected collections from the September to October 2015 Tax Amnesty program.
- Increased balance forward from FY 2015. The original budget assumed an ending balance of \$12 million for FY 2015. The actual balance carried forward into FY 2016 was \$312 million, an increase of \$300 million.
- An increase of \$107 million in FY 2016 expenditures, including \$52 million for General Fund spending required assuming the passage of Proposition 123 at the May Special Election, \$29 million for supplementals including \$21 million for higher-than-projected Medicaid behavioral health spending and \$5 million for increased health care contract rates at the Department of Corrections, \$15 million for higher-than-expected administrative adjustments (expenditures for FY 2015 bills received in FY 2016), and \$9 million for the cost of the May Special Election.

FY 2017 Baseline Revenues

Base revenues are forecast to grow in FY 2017; in addition, one-time revenues are projected to grow slightly from FY 2016 to FY 2017. Overall FY 2017 collections would increase to \$10.0 billion, or \$256 million above the revised FY 2016 estimate for the following reasons:

- Based on JLBC's 4-sector consensus, FY 2017 base revenues are projected to grow by \$389 million, or 4.0%. Base revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing and new tax law changes.
- The growth in base revenues would be accompanied by an increase in the balance forward as the FY 2016 carry forward into FY 2017 of \$499 million is \$187 million higher than the FY 2015 carry forward of \$312 million.
- The state set-aside for urban revenue sharing formula distributions would increase from \$606 million to \$664 million, thereby decreasing state revenue by \$(58) million.
- Previously enacted legislative changes would reduce state revenue by \$(98) million, primarily from the continued phase-in of a corporate income tax rate reduction from 6.968% to 4.9%, the phase-in of a change in how multi-state corporations are permitted to treat sales in calculating tax liability ("corporate sales factor"), and an increase in the cap for the corporate school tuition organization tax credit.
- The FY 2017 Baseline excludes \$47 million from the fall 2015 Tax Amnesty program that would not be continued.
- Discontinuing FY 2016 fund transfers would reduce revenue by \$(217) million, offset by a previously-enacted FY 2017 fund transfer of \$100 million from the state's Health Insurance Trust Fund.
- Including all tax law changes and other adjustments, revenues would grow from \$9.74 billion to \$10.0 billion, or 2.6%.

The 4-sector estimate was developed using a consensus forecasting process. This consensus equally weights the results of 4 forecasts:

- The Finance Advisory Committee (FAC), an independent 14-member group of public and private sector economists;
- The University of Arizona Economic and Business Research (EBR) Center's econometric forecasting baseline model;
- The EBR's conservative forecast model; and
- The JLBC Staff forecast.

The FY 2017 base revenue growth rate of 4.0% reflects modest growth, reflecting the continuation of recent trends:

- Core General Fund revenues -- sales tax and individual income tax withholding -- remain below historical norms.
- Sales tax and withholding growth in FY 2015 was 4.7% and 3.4%, respectively; in the first half of FY 2016, those figures are 2.5% and 2.8%, adjusted for amnesty.
- Lower growth rates potentially reflect the ongoing impact of the Great Recession, as well as the state's larger size.
- Corporate tax is difficult to forecast -- in 22 of the past 28 fiscal years, annual change has been greater than +/- 10%.

(See the General Fund Revenue section for more information.)

FY 2017 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2017 Baseline spending is projected to be \$9.37 billion, a \$130 million, or a 1.4%, increase above FY 2016. The major adjustments are:

- Department of Education spending would increase by \$84 million due to 1.4% growth in student enrollment, a 1.15% inflation factor, and a higher state share of homeowner K-12 property taxes. The Baseline includes savings associated with eliminating the "hold harmless" provision for district student growth declines and Joint Technical Education District (JTED) formula reductions as enacted in the FY 2016 budget.
- The Baseline assumes passage of Proposition 123 at the May 2016 Special Election, which would have a total fiscal impact of \$299 million in FY 2016. The funding would be generated from increasing the State Land Trust distribution rate from 2.5% to 6.9% per year (\$172 million), adding \$52 million in new General Fund monies and incorporating \$74.4 million of formerly separate "Additional Inflation" monies into Basic State Aid. The Proposition's 10-year impact would be \$3.5 billion.

- AHCCCS Medicaid spending would grow by a net of \$79 million, reflecting 2.5% caseload growth and a 1.5% capitation rate increase offset by a higher federal matching rate. The Baseline shifts \$517 million of behavioral health spending from DHS to AHCCCS in accordance with 2015 legislation requiring the transfer.
- The Department of Economic Security (DES) budget would also increase by \$24 million primarily for Developmental Disabilities Medicaid growth.
- Department of Corrections spending would increase \$23 million, including \$18 million for opening 1,000 medium-security private beds in September 2016 and \$5 million for previously-approved contract increases for inmate health care.
- One-time spending for capital, information technology and DCS backlog funding would not be repeated in FY 2017, reducing spending by \$(18) million.

The \$9.37 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 51,898 state employees.

Forecast Risks

As an estimate of state revenues and spending obligations, there are both positive and negative risks to the JLBC Baseline estimates. Because small percent changes in growth assumptions can have a substantial impact – over 3 years, a 1% change in base revenue growth could change available revenues by \$625 million through FY 2019 – these risks could significantly change the final results of these budgets.

The potential gains to the forecast include:

- Improving national economic recovery: The national economy has been improving since the second quarter of 2014. Stronger economic growth, better job prospects, and an increase in consumer confidence could translate into increased net migration to the state, which would also result in more demand for housing and an overall boost to the Arizona economy and related revenue growth.

The potential losses to the forecast include:

- Possibility of recession: The current expansion is 79 months in length, and is already significantly longer than the 58-month average for economic expansions since World War II. If the expansion were to continue through the end of FY 2019, it would equal the post-1991 economic expansion for longest expansion since World War II.
- Litigation expenses: Beyond the K-12 inflation litigation, which Proposition 123 addresses and whose impact has been incorporated into the Baseline presuming that it is approved at the May Special Election, the state faces other unresolved and potential litigation impacts that have not been incorporated into the Baseline. These impacts include the following:
 - Higher state employer contribution rates related to retirement litigation (a potential ongoing minimum of \$18 million): Only reflects potential impact for elected officials' retirement systems; potential annual impact on public safety and correctional retirement systems not yet calculated.
 - Hospital assessment litigation (a potential ongoing minimum impact of \$94 million): If the hospital assessment was eliminated, the state would at least have the cost of backfilling the assessment used to fund the mandatory Proposition 204 parents program. The cost would be substantially higher if childless adults were retained on the program.
 - Rental Car surcharge litigation (potential one-time impact of \$150 million): A Superior Court ruling that the rental car surcharge used to help fund the Arizona Sports and Tourism Authority is unconstitutional also stated that the state, and not the Authority, had the initial legal responsibility to pay the collected surcharges.
 - Foster care litigation (unknown potential impact): A 2015 suit filed in U.S. District Court alleges failures regarding access to care, timeliness of investigations, retaining foster homes, and maintaining family relationships.

JLBC Staff Suggested Budget Reforms and Process Improvements

Based on its review of agency requests in preparing this Baseline, the JLBC Staff has developed several suggestions to improve legislative oversight and transparency of government spending, including:

Do Not Overcommit One-Time Cash Balance: The FY 2017 Baseline has an estimated ending cash balance of \$625 million, but a structural balance of just \$26 million. While this structural Baseline balance is estimated to grow to \$325 million by FY 2019, that estimate assumes no discretionary initiatives will be approved during the next 3 years. Expending the one-time cash for ongoing programs in FY 2017 would recreate the structural shortfall in FY 2018 and FY 2019.

Dedicate One-Time Revenues for One-Time Spending: The Legislature has several options for using the cash balance for one-time purposes that would not generate a structural shortfall. These options include:

- Paying off some of \$1.2 billion of “rollovers” (deferrals of current-year obligations to the following fiscal year).
- Funding Information Technology initiatives: the Department of Revenue (DOR) and DCS are two departments considering multi-million dollar replacements of current systems.
- Infrastructure and other capital improvements, including supplementing Highway User Revenue Fund (HURF) spending for state and local transportation projects with General Fund monies
- Paying off some of the \$1.1 billion of operating budget-related debt incurred during the Great Recession.

Establish Formal Process for Future Unanticipated Revenues: The Legislature may consider whether to deposit one-time revenues into a new special initiatives fund for one-time purposes. One-time revenues would include higher-than-expected General Fund balances and unusually large income tax collections from capital gains. The latter would require developing a reporting mechanism for “excess” capital gain tax growth so as to permit the deposit of these monies into the one-time special initiatives fund.

While the tax base for most General Fund revenue categories is fairly stable over time, other revenue sources are inherently volatile. For example, it is not unusual for capital gains and corporate income tax to grow at double-digit rates in one year only to be followed by double-digit rate declines in the next year. Such large swings in revenue collections make the budgeting process more difficult.

Voters in California approved a ballot measure (“Proposition 2”) in 2014 that requires the state to deposit any “excess” revenue from capital gains taxes into its Rainy Day Fund. In addition, the state deposits 1.5% of its General Fund revenue into the fund. Half of the fund remains in reserve while the other half is used to buy down state debts, including unfunded retirement and operating loans.

Increase Oversight of DCS Transfers: Due to the scale and number of the transfers DCS made between its line items, the JLBC Staff has concerns that DCS may not be allocating resources in a manner consistent with legislative intent and suggests the Legislature consider requiring JLBC review before any transfer of resources among DCS line items. In particular, DCS has moved substantial resources from in-home to out-of-home services.

Revise Legislatively-REFERRED Measure on Land Department Administration: In 2015, the Legislature approved SCR 2018, which will allow voters in the November 2016 general election to decide whether to amend the Arizona Constitution to allow up to 10% of annual proceeds from state trust land to be used for administration and disposition of trust lands. The Baseline would modify the referral and other permanent law to clarify the uses of the trust land proceeds, increase legislative oversight and reduce the potential beneficiary impact.

Clarify “1% Cap” Process: The FY 2016 Baseline noted that while the Arizona Constitution prohibits homeowners from paying more than 1% of their assessed value in primary property taxes from all sources, the Constitution does not specify the solution if a local jurisdiction exceeds 1%. The state has effectively picked up all the difference. The FY 2016 budget included a provision to share that obligation among the relevant jurisdictions, but the JLBC Staff suggests that the Legislature consider additional legislation to clarify the process.

Treat All University Tuition Collections Similarly: Tuition collections are split between appropriated and non-appropriated amounts. To increase transparency, the JLBC Staff recommends that tuition collections either be fully appropriated or fully non-appropriated and that tuition and fees be reported separately from other University revenues.

Improve Reporting on Corporate Tax Credits: The FY 2016 Baseline included provisions requiring more timely fiscal year individual income tax credit reporting by DOR and insurance premium tax reporting by the Department of Insurance. The FY 2016 budget included both provisions. The Baseline extends these requirements to include DOR reporting on corporate income tax credits.

In addition, the Legislature may consider these further suggestions:

- **Inpatient Psychiatric Treatment for Youth (AHCCCS):** The Baseline includes a provision requiring AHCCCS to report on the availability of inpatient psychiatric treatment for child and adolescents enrolled in Arizona's Regional Behavioral Health Authorities.
- **Square Footage of School Facilities (School Facilities Board):** The JLBC Staff suggests the Legislature consider further limiting the amount of locally-funded space that is excluded when determining a district's eligibility for state-funded space. Districts are allowed to exclude up to 25% of their space if locally funded. This adjustment can lead to significant new school construction awards when a district is not over capacity when all space is considered.
- **University Performance Funding:** The Arizona Board of Regents (ABOR) requested FY 2017 state funding based on the number of resident students enrolled at each campus instead of using a performance funding model as required by the FY 2016 General Appropriation Act. In evaluating this proposal, the JLBC Staff suggests the Legislature also consider the alternatives of reforming the existing performance funding model, or eliminating the funding model altogether.
- **Private Equity Fee Report (Retirement systems):** The JLBC Staff suggests the Legislature consider requiring the Arizona State Retirement System and the Public Safety Personnel Retirement System to adopt a specific template for private equity fees and report annually on the total cost and overall performance of private equity investments. The reporting would be designed so as to not impair investment performance.

Further details on the issues raised here can be found in the relevant agency narrative.

Update on FY 2016 Suggestions

The JLBC Staff made the following suggestions for improvement in the FY 2016 Baseline:

Develop Multi-Year Targets and Formalize in General Appropriation Act: The JLBC Staff recommended that the General Appropriation Act include a multi-year plan for resolving budget shortfalls with specific out-year targets. The FY 2016 General Appropriation Act listed the targets, which included a \$27 million FY 2018 balance prior to subsequent legislation.

Annual Retirement Report: The JLBC Staff recommended a new statutory report separately delineating the state's retirement expenses and incorporated a new section, the Consolidated Retirement Report, in the *FY 2016 Baseline Book* which provides this information. The FY 2016 budget included this provision.

Review of Acute and Behavioral Health Services Integration: The JLBC Staff suggested that the Legislature evaluate accountability measures as it considers further consolidation of the acute and behavioral health services systems. The FY 2016 budget transferred behavioral health services from the Department of Health Services to AHCCCS but did not incorporate accountability measures into the bill.

In addition to these items affecting overall budget or multiple agencies, the FY 2016 Baseline also included these agency-specific suggestions:

- **Contracted Health Care Rates (Arizona Department of Corrections):** The Baseline included a provision requiring increases in ADC contracted health per diem rates to be reviewed by JLBC, similar to the current process used in the Medicaid program. The FY 2016 General Appropriation Act included this provision, which was used in June 2015.
- **Division of Developmental Disabilities (DDD) Budget Transparency (Department of Economic Security):** The Baseline separately delineated DDD administrative expenditures to help provide a total budget picture of DDD services. This distinction was included in the FY 2016 Department of Economic Security budget.
- **Proposition 301 0.6% Sales Tax Planning (Arizona Department of Education):** The Proposition 301 sales tax was set to expire after FY 2021; the JLBC Staff recommended that the Legislature begin a planning process to accommodate this expiration. This was not addressed during the regular session.

- Intergovernmental Agreement Funding Transparency (Department of Health Services): The Baseline included a provision to divide DHS' Intergovernmental Agreements/Interagency Service Agreements Fund into 4 separate funds to ensure that monies are not inappropriately comingled. The FY 2016 budget included this provision.
- Probation and Automation Transparency (Judiciary): The Baseline shifted funding within the Judiciary's budget in order to better align expenditures with appropriations and bring transparency to how much money the Judiciary transfers to counties for probation activities and how much money the Judiciary spends on other activities. The Judiciary's FY 2016 budget incorporated these shifts.
- Local K-12 Bonding Report (School Facilities Board): The Baseline included a provision requiring SFB to report annually on capital bond approvals by school districts to provide a better understanding of bond issuances and school construction occurring outside of state funding. The FY 2016 budget included this provision.
- Displaying Rio Nuevo Expenditures (Revenues): The Baseline shifted the display of Rio Nuevo expenditures from being an offset to General Fund revenue to being an operating budget expenditure, increasing transparency and conforming its display with that of the Phoenix Civic Center payment. Subsequent budget documents continue this display.

Debt

In FY 2017, the state's projected level of lease-purchase and bonding obligations is \$7.4 billion. This amount includes:

- \$3.4 billion, state and university office buildings
- \$1.7 billion, state highway construction projects
- \$1.1 billion, state operating debt from FY 2011
- \$946 million, school district projects
- \$260 million, Phoenix Convention Center

The associated annual debt service payment is \$891 million.

Of the \$7.4 billion in total obligations, the General Fund share is \$2.7 billion. The General Fund annual debt service is projected to be \$367 million in FY 2017.

As a remnant of the Great Recession, the state pays \$1.2 billion of current year obligations in the next year (the "rollover"). The \$7.4 billion estimate of total obligations also does not include any unfunded retirement liability.

In May 2015, both major credit rating agencies upgraded Arizona's credit rating. Standard & Poor's upgraded Arizona from AA- to AA, while Moody's upgraded Arizona from Aa3 to Aa2. Both ratings represent the agencies' third highest rating out of 10 possible levels. Using Moody's credit ratings as of May 2015, in comparison to other states, 25 states have a higher rating, 9 states have a similar rating, and 15 states have a lower rating or are not rated due to a lack of state level debt. Along with an overall rating, credit agencies also provide an outlook in terms of the future direction of rating changes. As of May 2015, both major agencies have a stable outlook for Arizona.

Other Funds

Besides the General Fund, the state has dedicated special revenue funds. Only a portion of these monies is subject to legislative appropriation. The Baseline includes a FY 2017 Other Fund appropriated spending level of \$3.9 billion, or 0.1% above FY 2016.

The level of FY 2017 non-appropriated state funds is expected to be \$8.5 billion, while non-appropriated Federal Funds are forecast to be \$14.6 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2017 state spending would be \$36.3 billion.

**STATEMENT OF GENERAL FUND REVENUES AND EXPENDITURES 1/
WITH ONE-TIME FINANCING SOURCES**

	FY 2016 Adjusted	FY 2017 Baseline	FY 2018 Baseline	FY 2019 Baseline
REVENUES				
Ongoing Revenues	\$9,769,648,500	\$10,158,379,200	\$10,521,214,000	\$10,905,740,800
Previously Enacted Changes		(97,800,000)	(90,400,000)	(73,300,000)
Urban Revenue Sharing	(605,634,300)	(663,652,100)	(676,193,800)	(682,236,800)
Net On-going Revenues	\$9,164,014,200	\$9,396,927,100	\$9,754,620,200	\$10,150,204,000
One-time Financing Sources				
Balance Forward	\$312,276,000	\$499,325,500		
Tax Amnesty	47,048,500			
Fund Transfers	217,017,700	100,000,000		
Subtotal One-time Revenues	\$576,342,200	\$599,325,500	\$0	\$0
Total Revenues	\$9,740,356,400	\$9,996,252,600	\$9,754,620,200	\$10,150,204,000
EXPENDITURES				
Operating Budget Appropriations	\$9,230,421,600	\$9,410,928,500	\$9,646,908,000	\$9,865,437,300
Supplementals	29,409,300			
Administrative Adjustments	85,000,000	70,000,000	70,000,000	70,000,000
Revertments	(110,000,000)	(110,000,000)	(110,000,000)	(110,000,000)
Subtotal Ongoing Expenditures	\$9,234,830,900	\$9,370,928,500	\$9,606,908,000	\$9,825,437,300
One-time Expenditures				
Capital Outlay	\$6,200,000			
Subtotal One-time Expenditures	\$6,200,000	\$0	\$0	\$0
Total Expenditures	\$9,241,030,900	\$9,370,928,500	\$9,606,908,000	\$9,825,437,300
Ending Balance <u>2/</u>	\$499,325,500	\$625,324,100 <u>3/</u>	\$147,712,200	\$324,766,700
Structural Balance <u>4/</u>	(\$70,816,700)	\$25,998,600	\$147,712,200	\$324,766,700

- 1/ Significant one-time revenues and expenditures are separately detailed so as to permit the calculation of ongoing revenue and expenditures.
- 2/ This calculation reflects the difference between total revenues and total expenditures. Excludes any Budget Stabilization Fund balance.
- 3/ The projected FY 2017 ending balance is presumed to be allocated as part of the FY 2017 budget process.
- 4/ This calculation reflects the difference between ongoing revenues and expenditures and excludes one-time adjustments. Excludes any Budget Stabilization Fund balance.