FY 2018 BASELINE SUMMARY

Overview

The FY 2018 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.

The JLBC Baseline parameters are as follows:

- Total FY 2018 General Fund revenue is projected to be $9.72 billion. Base revenues are forecast to grow by $394 million, or 3.9% above FY 2017. After adjusting these estimates for previously enacted tax law changes and the elimination of one-time monies, however, net revenue growth would only be $20 million, or 0.2% above FY 2017.
- In comparison, FY 2018 Baseline formula spending is projected to be $9.60 billion. This amount reflects a $(25) million, or (0.3)%, decline in expenditures from FY 2017. Spending on current funding formulas would be offset by elimination of one-time FY 2017 spending.
- The projected FY 2018 cash balance is $118 million. When comparing ongoing revenues with ongoing spending, however, the structural balance is only $46 million.

The Baseline can be used to determine the level of resources available for new initiatives, either in terms of new spending or tax reductions. The structural balance of $46 million and the cash balance of $118 million, however, likely overstates the availability of funds for 2 reasons:

- The Baseline eliminates over $240 million of spending that was labeled as "one-time" in the FY 2017 budget. There may be legislative interest in retaining some of this spending. The list of possible retention candidates is $130 million *(see Table 1).*
- The Baseline does not include the preliminary estimate of $23 million to fund the annual cost of provider rate increases for Proposition 206 minimum wage requirements.

Table 1

Possible Retention Candidates

One-Time '17 Funding	$ in M
ADE IT System	7
ADE Statutory Expirations	50
SFB Building Renewal	15
Universities	19
County Assistance	38
Total	**130**

The retention candidates and the minimum wage adjustments would cost a combined $153 million. If they were all funded, the $118 million cash balance would become a shortfall.

Prior to considering the use of the FY 2018 balance for any new initiatives, the Legislature should first determine whether any of the $153 million is to be funded in the FY 2018 budget.

Recession Stress Test

Any budget can also be evaluated for its ability to determine whether its reserves are sufficient in the event of a recession. While the Baseline envisions continued economic growth, the current nationwide expansion is nearing a historic length. In a mild to moderate recession, General Fund revenues could be expected to fall by (5)% in FY 2018, compared to the forecasted base revenue growth of 3.9%.

Table 2

FY 2018 Cash Balances

	$ in M
Baseline	118
Recession Stress Test	(778)

In that type of "stress" test, revenue levels would decline by $(896) million compared to the Baseline, and the FY 2018 budget would have a cash shortfall of $(778) million (*see Table 2*). In comparison, the state's Budget Stabilization Fund has a balance of approximately $460 million. That dollar amount represents about 4.8% of General Fund revenue. The rating agencies recommend that states have reserves of 8% to 10% of their General Fund revenues.

FY 2017

The FY 2017 ending balance is currently projected to be $73 million, an increase of $7 million from the original budget estimate of $66 million. Total revenues, including the beginning balance, are forecast to be $9.70 billion compared to spending of $9.63 billion. The net $7 million adjustment has 2 components:

- Including the beginning balance, revenues are $25 million higher than anticipated.
- Spending is projected to be $18 million higher than originally budgeted in FY 2017, primarily due to supplemental funding for K-12 formula costs in the Arizona Department of Education.

FY 2018 Baseline Revenues

Base revenues are forecast to grow in FY 2018 while one-time revenues are projected to decline from FY 2017 to FY 2018. Overall FY 2018 collections would increase by 0.2% to $9.72 billion, or $20 million above the revised FY 2017 estimate. The major adjustments are:

- Based on JLBC's 4-sector consensus, FY 2018 base revenues are projected to grow by $394 million, or 3.9%. Base revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing and new tax law changes (*see the General Fund Revenue section for more information*).
- The growth in base revenues would be partially offset by a $(170) million decrease in the balance forward between FY 2017 and FY 2018. The state started FY 2017 with a cash balance of $243 million, but that is projected to decline to $73 million at the start of FY 2018.
- The state set-aside for urban revenue sharing formula distributions would increase from $664 million to $681 million, thereby decreasing state revenue by $(17) million.
- Previously enacted legislative changes would reduce state revenue by $(107) million, primarily from the continued phase-in of corporate income tax reductions.
- Elimination of one-time FY 2017 fund transfers would reduce revenues by $(79) million.

FY 2018 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2018 Baseline spending is projected to decline by (0.3)% to $9.60 billion, or $(25) million less than FY 2017. The major adjustments are:

- Department of Education formula spending would increase by $79 million due to 1.4% growth in student enrollment, a 1.37% inflation factor, and growth in K-12 property taxes. The Baseline includes savings of $(50) million for the statutory expiration of certain programs.
- AHCCCS formula spending would grow by a net of $44 million, reflecting 1.6% caseload growth and a 3.0% capitation rate increase offset by a higher federal matching rate and a one-year moratorium on a health insurer fee. The Baseline does not address potential changes associated with a possible repeal of the federal Affordable Care Act.
- The Department of Economic Security (DES) budget would increase by $18 million primarily for Developmental Disabilities Medicaid growth. The Baseline does not include funding for Developmental Disabilities provider rate adjustments associated with Proposition 206 minimum wage requirements due to insufficient data about the magnitude of provider cost increases resulting from the initiative.
- Department of Corrections spending would increase $7 million for the annualization costs of opening 1,000 medium-security private beds in September 2016.
- University spending would decline by $(15) million, primarily due to the elimination of $19 million in one-time FY 2017 assistance.
- School Facilities Board funding would be reduced by $(16) million, as approximately 47% of building renewal grants were labeled as one-time in FY 2017.
- The elimination of one-time FY 2017 Department of Public Safety Border Strike Force equipment expenses would save $(15) million in FY 2018.
- County assistance would fall by $(38) million due to one-time FY 2017 spending for local Highway User Revenue Fund (HURF) support and a Department of Juvenile Corrections cost offset.

- One-time FY 2017 capital construction costs would save $(57) million in the Arizona Department of Transportation and $(18) million in the Arizona Department of Administration.

The $9.60 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 52,655.7 state employees.

Other Fiscal Challenges

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 2020 – these risks could significantly change the final results of these budgets.

Arizona's budget picture is better than most states, as one-third to one-half of states are experiencing difficulties such as required mid-year budget reductions or revenues below the budgeted forecast. *State Policy Reports*, a joint project of the National Conference of State Legislatures and the National Governors' Association, has currently ranked Arizona 14th in economic momentum.

Table 3

Fiscal Challenges

- Changes to federal Affordable Care Act
- Pending Litigation
- Retirement underfunding
- Loss of state tax auditors
- Federal fiscal and monetary policy

But the state faces a number of other challenges in putting together a FY 2018 budget. These challenges include:

- Potential Federal changes to the Affordable Care Act could cost between $100 million and $1.4 billion (*Please see Estimated Impacts of Changes to the Affordable Care Act for more information*). The starting date of any changes is unknown, but it may not occur until FY 2019.
- The state faces ongoing litigation such as:
  - The Hospital assessment lawsuit could cost between $100 and $250 million. The hospital assessment was enacted with less than a two-thirds vote. The plaintiffs contend that the enactment of an assessment requires that the two-thirds threshold be met under Proposition 108 to the Arizona Constitution. 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.
  - The Rental Car surcharge litigation has a potential one-time impact of $150 million. A Superior Court has ruled that the rental car surcharge used to help fund the Arizona Sports and Tourism Authority is unconstitutional as those monies are to be dedicated for transportation. The Court also ruled that the state, and not the Authority, had the initial legal responsibility to pay the collected surcharges.
- Under current assumptions, the state's retirement systems are underfunded, as the FY 2018 employer rates do not reflect the cost of the Arizona Supreme Court's decision in the *Hall* case, and the Elected Officials system is underfunded by about $30 million yearly.

There are also at least 2 challenges to forecasting revenues in FY 2018:
- Revenue collections may be affected by a one-third reduction in the number of audit staff at the Department of Revenue (DOR). The Baseline forecast has not been adjusted to account for these staffing changes.
- Federal fiscal and monetary policy changes may affect the performance of the broader economy. Tax reductions and infrastructure spending may boost the economy, but such a stimulus could be offset if the federal deficit grows or the Federal Reserve raises interest rates.

Debt

At the end of FY 2018, the state's projected level of lease-purchase and bonding obligations will be $7.3 billion. The associated annual debt service payment is $941 million.

Of the $7.3 billion in total obligations, the General Fund share is $2.1 billion. The General Fund annual debt service is projected to be $354 million in FY 2018 (*see the Debt and Lease-Purchase Financing section of the Capital Outlay narrative for additional information*).

As a remnant of the Great Recession, the state also pays $931 million of current year K-12 obligations in the next year (the "rollover"). The $7.3 billion estimate of total obligations also does not include any unfunded retirement liability.

Arizona's credit rating was last changed 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 Standard & Poor's credit ratings as of November 2016, 28 states have a higher rating, 12 states have the same rating, and 9 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 2018 Other Fund appropriated spending level of $4.1 billion, or 0.5% above FY 2017.

The level of FY 2018 non-appropriated state funds is expected to be $9.1 billion, while non-appropriated Federal Funds are forecast to be $15.5 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2018 state spending would be $38.3 billion.