

FY 2019 BASELINE SUMMARY

Overview

The FY 2019 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 2019 General Fund revenue is projected to be \$9.95 billion. Base revenues are forecast to grow by \$368 million, or 3.6% above FY 2018. After adjusting these estimates for previously enacted tax law changes and the elimination of one-time monies, however, net revenue growth would only be \$140 million, or 1.4% above FY 2018.
- In comparison, FY 2019 Baseline formula spending is projected to be \$10.06 billion. This amount reflects a \$228 million, or 2.3%, increase in expenditures over FY 2018. Spending on current funding formulas would be partially offset by elimination of one-time FY 2018 spending.
- The projected FY 2019 cash shortfall is \$(108) million. When comparing ongoing revenues with ongoing spending, however, the structural shortfall is \$(11) million.

Table 1	
Possible Retention Candidates	
<u>One-Time '17 Funding</u>	<u>\$ in M</u>
ADE IT System	7
SFB Building Renewal	17
Universities	15
DES - DD Prop 206	12
State Employee Health	25
Counties - DJC/Other	10

The Baseline can be used to determine the level of changes, either in spending or revenues, necessary to bring the budget into balance. The structural shortfall of \$(11) million and cash shortfall of \$(108) million may understate the necessary level of changes to produce a balanced budget. The Baseline eliminates over \$89 million of spending that was labeled as "one-time" in the FY 2018. There may be legislative interest in retaining some of this spending (see Table 1), as well as in other new discretionary spending or tax decreases.

FY 2018

The FY 2018 budget is currently projected to have a \$(20) million shortfall, a decrease of \$(58) million from the original budget estimate of a \$38 million balance. Total revenues, including the beginning balance, are forecast to be \$9.81 billion compared to spending of \$9.83 billion. The net \$(58) million adjustment has 2 components:

- Including the beginning balance, revenues are \$(45) million less than anticipated.
- Spending is projected to be a net \$13 million higher than originally budgeted in FY 2018 primarily due to a Department of Education supplemental (see Statement of General Fund Revenues and Expenditures).

FY 2019 Baseline Revenues

Base revenues are forecast to grow in FY 2019 while one-time revenues are projected to decline from FY 2018 to FY 2019. Overall FY 2019 collections would increase by 1.4% to \$9.95 billion, or \$140 million above the revised FY 2018 estimate. The major adjustments are:

- Based on JLBC’s 4-sector consensus, FY 2019 base revenues are projected to grow by \$368 million, or 3.6%. 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). This estimate excludes any impact associated with the recently enacted federal tax law changes.

- The growth in base revenues would be partially offset by a \$(151) million decrease in the balance forward between FY 2018 and FY 2019. The state started FY 2018 with a cash balance of \$151 million, but that is projected to be completely eliminated at the start of FY 2019 as the FY 2018 budget is currently estimated to have a \$(20) million shortfall.
- The state set-aside for urban revenue sharing formula distributions would decrease from \$681 million to \$675 million, thereby increasing state revenue by \$6 million.
- Previously enacted legislative changes would reduce state revenue by \$(75) million, primarily from the continued phase-in of corporate income tax reductions.
- Elimination of one-time FY 2018 fund transfers would reduce revenues by \$(8) million.

FY 2019 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2019 Baseline spending is projected to increase by 2.3% to \$10.06 billion, or \$228 million more than FY 2018. The major adjustments are:

- Department of Education formula spending would have a net increase of \$168 million due to 1.3% growth in student enrollment, a 1.77% inflation factor, and a new 1.06% teacher pay adjustment. These growth factors would be partially offset by savings associated with higher K-12 property tax collections and trust land endowment earnings.
- AHCCCS formula spending would grow by a net of \$84 million, reflecting 2.0% caseload growth, a 3.5% rate increase, and elimination of one-time savings for a 1-year moratorium on a federal health insurer fee.
- The Department of Economic Security (DES) budget would increase by \$52 million primarily for Developmental Disabilities Medicaid growth.
- Department of Corrections spending would decrease \$(12) million for the elimination of a one-time health insurance adjustment.
- University spending would increase by \$7 million due to an increase of \$27 million for the first year of the 2017 Capital Infrastructure program, partially offset by the elimination of \$(15) million in one-time FY 2017 assistance and \$(5) million for a one-time health insurance adjustment.
- School Facilities Board funding would be reduced by \$(52) million, reflecting the elimination of \$(17) million of one-time building renewal monies and \$(35) million for decreased lease-purchase debt obligations. The Baseline includes a total of \$88 million for new construction, including \$38 million for the second and final year of FY 2018 authorizations and \$50 million for the first year of 5 new FY 2019 authorizations.
- County assistance would fall by \$(10) million due to the elimination of one-time FY 2018 spending for 3 large rural counties and a Department of Juvenile Corrections cost offset. The Baseline continues to include \$30 million from non-General Fund sources for local Highway User Revenue Fund (HURF) in FY 2019 to fully offset the local HURF "sweep." This offset has already been enacted for FY 2019.
- Agency budgets would be reduced by \$(25) million statewide to eliminate a one-time state employer health insurance increase; the majority of these savings are reflected in the agencies listed above.

The \$10.06 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 53,150 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 \$635 million through FY 2021 – these risks could significantly change the final results of these budgets.

The state faces a number of other challenges in putting together a FY 2019 budget. These challenges include:

- Federal tax reform passed by Congress at the end of 2017 will provide distinct budgeting challenges. Arizona will need to decide whether to continue to conform its definition of state taxable income for individual and corporate taxes to the federal definition. Conforming with the recently-enacted federal tax legislation changes could have a significant fiscal impact. As of this writing, this highly complex federal legislation is still being analyzed.
- The length of the current economic recovery is approaching the record for the longest post-World War II expansion. If the economy makes it through FY 2019 without a recession, it would tie the record at 120 months.

- Retirement system underfunding is not addressed in the Baseline in 2 ways:

- New retirement rates in the Arizona State Retirement System (ASRS), Corrections Officer Retirement Plan (CORP) and Public Safety Personnel Retirement System (PSPRS) systems could result in up to \$29 million in new General Fund costs.
- The Elected Officials' Retirement Plan (EORP) is currently estimated to become insolvent in 9 years. The current General Fund contribution is \$5 million. The General Fund cost of making the system sustainable is an additional \$5 million for state elected officials.

Table 2

Fiscal Challenges

- Federal Tax Changes
- Length of Expansion
- Retirement System Underfunding
- Pending Litigation

- The state faces ongoing litigation such as:

- The K-12 Capital Funding litigation in Maricopa Superior Court.
- Litigation against the Department of Child Safety in United States District Court. The case was recently granted class-action status.
- The Rental Car surcharge litigation has a potential one-time impact of \$150 million. A Maricopa 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.

Debt

At the end of FY 2019, the state’s projected level of lease-purchase and bonding obligations will be \$6.8 billion. The associated annual debt service payment is \$884 million.

Of the \$6.8 billion in total obligations, the General Fund share is \$1.9 billion. The General Fund annual debt service is projected to be \$321 million in FY 2019 (*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 \$6.8 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 Moody's credit ratings as of January 2017, in comparison to other states, 32 states have a higher rating, 10 states have the same rating, and 7 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. Since May 2015, both major agencies have maintained a stable outlook for Arizona.

More recently, Standard & Poor's upgraded its rating on Arizona's 2010 Lottery bonds to AA+ from AA. While the rating only applies to the Lottery bonds and not the state's overall rating, Standard & Poor's cited the state's broad and diverse population base and growth in the past decade as one reason for the improved outlook.

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 2019 Other Fund appropriated spending level of \$4.3 billion, or (1.9)% below FY 2018.

The level of FY 2019 non-appropriated state funds is expected to be \$9.5 billion, while non-appropriated Federal Funds are forecast to be \$16.3 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2019 state spending would be \$40.1 billion.