

**Joint Legislative Budget Committee
Staff Memorandum**

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DATE: October 17, 2006

TO: Members, Joint Legislative Budget Committee

FROM: Richard Stavneak, Director

SUBJECT: FY 2007 REVENUE AND ENDING BALANCE PROJECTION

Pursuant to Laws 2006, Chapter 344, the JLBC Staff is required to report to the Committee by October 15, 2006 as to whether the estimated revenue and ending balance for FY 2007 are expected to change by more than \$50 million from budgeted projections.

The JLBC Staff does anticipate that the FY 2007 ending balance will exceed the budget by more than \$50 million due primarily to a higher than budgeted carry-forward from FY 2006. As discussed below, there are 3 main factors which we anticipate will influence the magnitude of the increase in the FY 2007 ending balance.

FY 2006 Revenue Performance

As enacted in June, the FY 2006 General Fund revenue forecast (excluding the beginning balance) was \$9,153.7 million. Preliminary actual FY 2006 revenue collections exceeded this forecast by approximately \$126 million. As a result, a total of \$126 million in excess revenue collections will carry forward into FY 2007.

The actual amount of the carry-forward will also depend on the level of final FY 2006 spending. The General Appropriation Act requires that the Executive Branch submit a preliminary estimate of the FY 2006 ending balance by September 15, 2006. The Executive has not yet submitted this report.

FY 2007 Revenues

The enacted FY 2007 budget was based on a total revenue forecast (excluding the beginning balance) of \$9,478.0 million. This amount assumed a baseline revenue growth rate of 7.7%. Based on the higher than expected FY 2006 collections noted above, the enacted budget forecast amount results in a baseline growth rate for FY 2007 of 6.4%.

Due to several factors, revenue growth is expected to slow throughout the course of the year. For example, most of the impact of the 5% reduction in individual income taxes will not be felt until the spring tax filing period. As a result, the first quarter forecasted growth rate is 8.2%, compared to the projected overall annual growth rate of 6.4%.

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Based on preliminary data, General Fund revenues were 9.0% above FY 2006 collections through the first 3 months of the fiscal year. Given the first quarter projected growth rate of 8.2%, revenues are approximately \$19 million above forecast.

While still healthy, FY 2007 revenue growth is clearly below the 20% pace of FY 2006. There were several notable aspects to the 1st quarter performance:

- Corporate income tax remained strong with collections more than 14% above last year.
- Individual income tax estimated payments grew by over 29%, but this may reflect a reaction to taxpayers having large final payments last spring. To avoid being penalized for underreporting, taxpayers may have increased their estimated payment levels. There is no indication, however, that actual tax liability is increasing at a rate of 29%. As a result, some of these estimated payments may be returned as higher refunds later in the year.
- Withholding tax collections grew by only 5% during the quarter, due in part to one less processing day. Adjusting for the number of days, it is estimated that withholding would have increased by approximately 6.5%. In comparison, withholding grew by 16% in FY 2006.
- Contracting sales tax collections grew by almost 19% during the first 2 months of the fiscal year (September data is not yet available). This level of growth is surprising with the slowdown in residential housing. The on-going strength of this category may reflect a shift toward more commercial construction.
- Retail sales have clearly slowed from prior years, with growth for the first 2 months of the fiscal year below 5%. In FY 2006, retail sales increased by 14.5%.

As noted above, preliminary 1st quarter collections are \$19 million above forecast. Without the questionable increase in estimated income tax payments, this growth would be down to \$6 million. Extrapolating this result to a full year would result in surplus revenue of \$24 million.

The JLBC's four sector consensus model offers a more optimistic view of the economy. This process equally weights the forecast from the Finance Advisory Committee, the base and low forecasts from the University of Arizona econometric models, and the JLBC Staff forecast. The September four sector consensus forecast for FY 2007 is 8.0%. At this growth rate, year-end revenues would exceed the forecast by \$165 million.

FY 2007 Spending

The FY 2007 ending balance will also depend on whether we meet spending projections. Five of the largest agencies report either monthly or bi-monthly on their spending. While some agencies report shortfalls, these may be offset by surpluses elsewhere:

- *Arizona Department of Education (ADE)* – ADE reports no shortfall.
- *AHCCCS* – Caseloads are currently below the forecast utilized in the FY 2007 budget. While the department's most recent Appropriation Status Report did not include an estimate of the surplus in FY 2007, it could be between \$20 million and \$30 million.

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- *Department of Economic Security* – The department reports that the Children Services programs in the Division of Children, Youth and Families may have a FY 2007 shortfall of \$(19) million due to changes in federal law as well as higher than budgeted caseloads in those programs. While the department reports these as potential issues, they do not report an overall department-wide shortfall for the year at this time.
- *Department of Health Services* – As with AHCCCS, Title 19 caseloads are currently below the forecast utilized in the FY 2007 budget. While the department’s most recent 30th of the Month Report did not include an estimate of the surplus in FY 2007, it could be as high as \$7 million.
- *Arizona Department of Corrections (ADC)* – ADC has indicated that increases in overtime and compensatory time expenditures could potentially result in a FY 2007 budget shortfall of \$(21.3) million.

Summary

The enacted FY 2007 budget had an estimated FY 2007 ending balance of \$174.0 million. The following chart summarizes potential adjustments to this amount. This estimate may be subject to considerable change during the remainder of the fiscal year.

Potential Adjustments to FY 2007 Ending Balance

	<u>\$ in millions</u>
Unanticipated FY 2006 revenues	\$ 126
Excess FY 2007 revenues	24 - 165
Supplementals – to be determined	- -
Total-Potential Adjustments to Ending Balance	<u><u>\$ 150 - 291</u></u>

The enacted budget had a projected FY 2007 ending balance of \$174 million. These potential adjustments would increase that amount by a range of \$151 million to \$291 million. These monies would be available in FY 2008 to replace the \$730 million in one-time monies used to balance the original FY 2007 budget, as well as to fund normal FY 2008 caseload growth.

TE:ym

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