
Finance Advisory Committee

Revenue and Budget Update

January 24, 2019

JLBC

Three Aspects of Creating a Budget

- Manage risk in setting the forecast
- Set priorities
- Ensure both a structural and cash balance through the 3-year planning period ('20 – '22)

Key Points About Our Current Budget Status

- ❑ JLBC Baseline annually compares a consensus revenue estimate to statutory spending requirements
- ❑ Strong economic growth has substantially improved the state's fiscal condition
- ❑ The General Fund is forecast to have a structural balance of \$200+ M
- ❑ In addition, the state is expected to have a 1-time balance of \$900+ M in '20

How Did We End Up with \$1 B Above Forecast

- Higher than expected revenue growth - '18 & '19 both 2% higher than budgeted

	\$ in M			
<u>Changes to '19's 3-Year Plan</u>	<u>'18</u>	<u>'19</u>	<u>'20</u>	<u>Total</u>
Higher '18 Revenue Base	212	222	231	665
Higher '19 Revenue Forecast	-	267	245	512
Revised Spending/URS	13	(5)	(35)	(27)
Total	<u>225</u>	<u>484</u>	<u>441</u>	<u>1,150</u>

Managing Risk in Setting a Forecast

Risk of a Recession Complicates Forecasting

- ❑ We will break record for longest economic U.S. expansion in July 2019
- ❑ Next recession? 2/3rds of 60+ economists in recent Wall Street Journal surveys say by the end of CY '20
- ❑ But recession is usually result of a “shock”, not old age
- ❑ No slowing at state level: 6.9% revenue growth in '18, 6.8% so far in '19

Arizona Ranks 4th in Economic Momentum

- Up From 14th in December 2017

	<u>AZ Rate</u>	<u>AZ Rank</u>
Personal Income	4.7%	14
Population	1.7%	4
Employment	3.6%	2

Momentum calculations via State Policy Reports – Joint NGA/NCSL Project

- ❑ State revenue growth is also strong – 6.9% in '18, 6.8% year to date in '19 (Appendix A)
- ❑ Through 12/2018, revenue growth is \$200 M above the budget forecast

How Does the 4-Sector Forecast Address Risk?

- Strong '19 Growth, then Below Average

January Consensus Forecast

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

Represents Net Growth

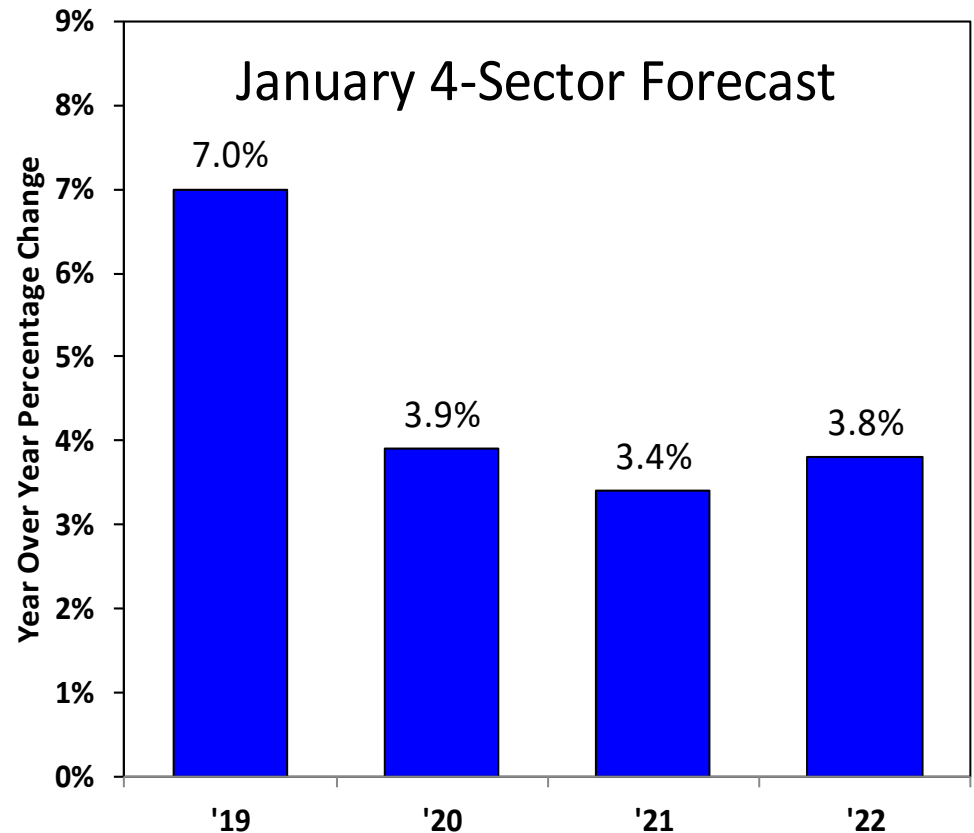
- Previously estimated gross

Chance of Exceeding Forecast

- 60%

Long Run Average Growth

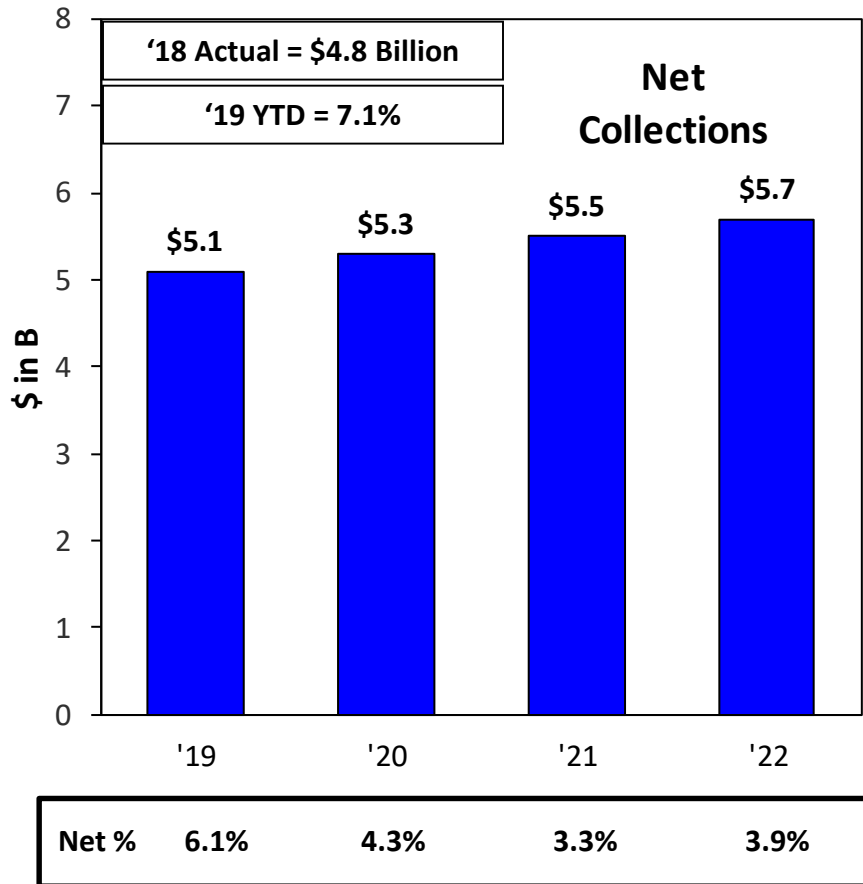
- 4.0%



Percent change in net revenues excluding balance forward, one-time transfers and urban revenue sharing

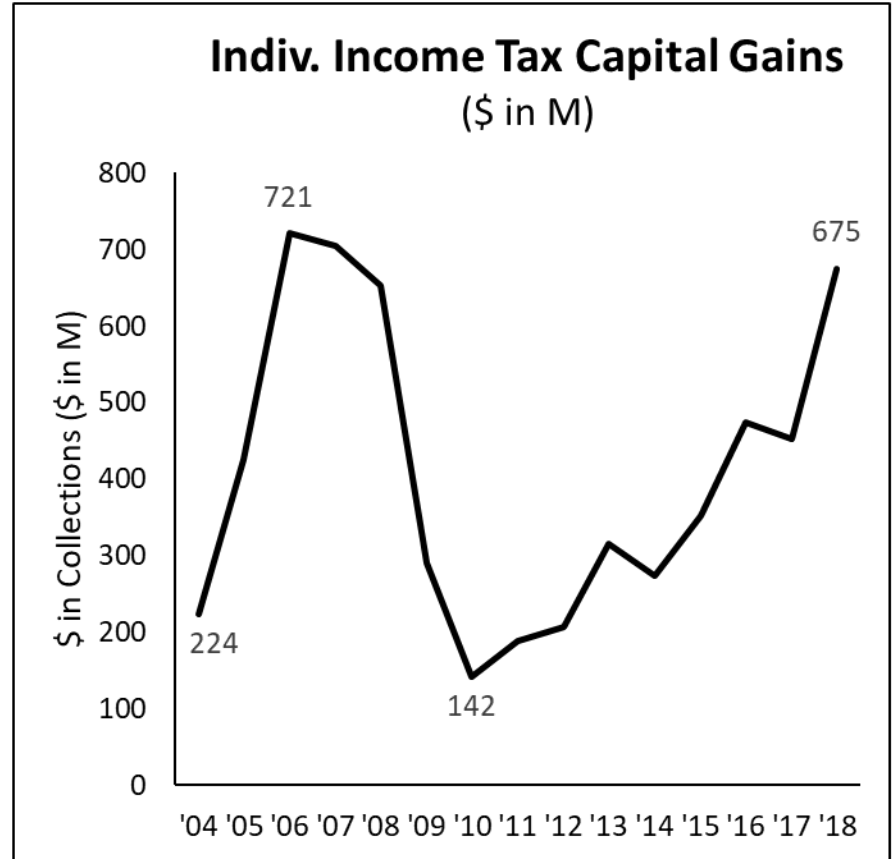
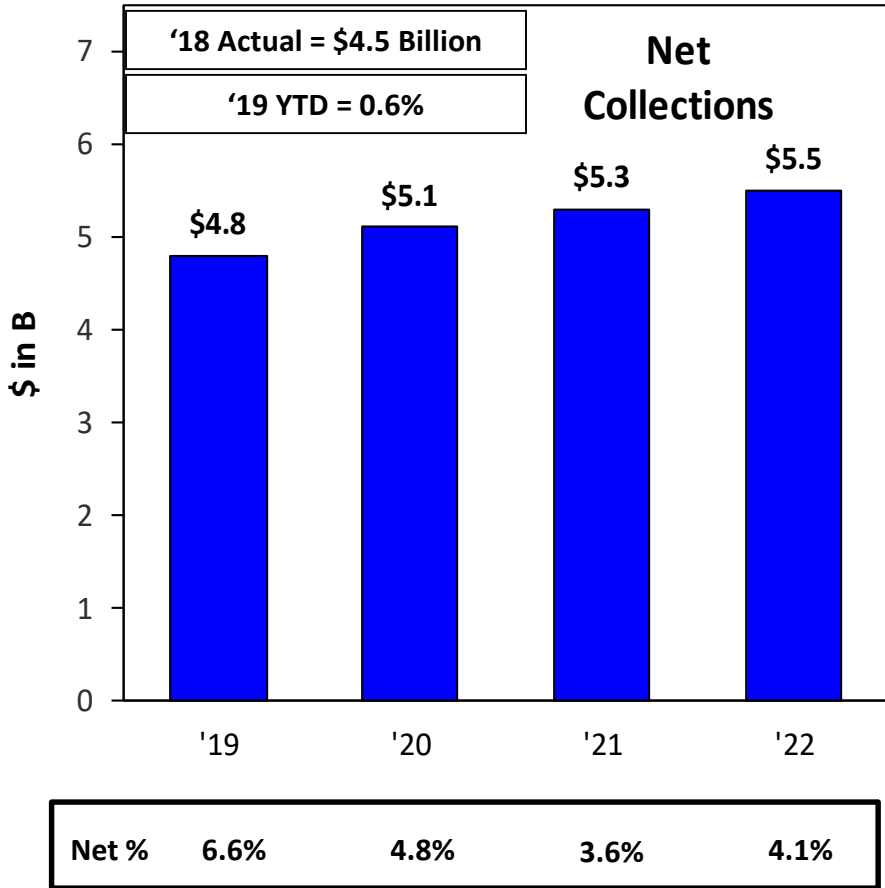
See Appendix B, C, D

Sales Tax



- ❑ In recent *South Dakota v. Wayfair Inc.* ruling, Supreme Court overturned physical presence (nexus) requirement.
- ❑ *Wayfair* cleared the way for states to start collecting sales tax from out-of-state sellers.
- ❑ However, *Wayfair* ruling suggests that states set a minimum collection threshold and provide a uniform, simplified tax structure.
- ❑ Any potential revenue from *Wayfair* ruling is not included in either the JLBC or Executive revenue base
- ❑ Federal report estimates that Arizona General Fund could gain \$85 M.

Individual Income Tax



Individual Income Tax

- December/January Shortfall

Individual Income Tax Payment Collections

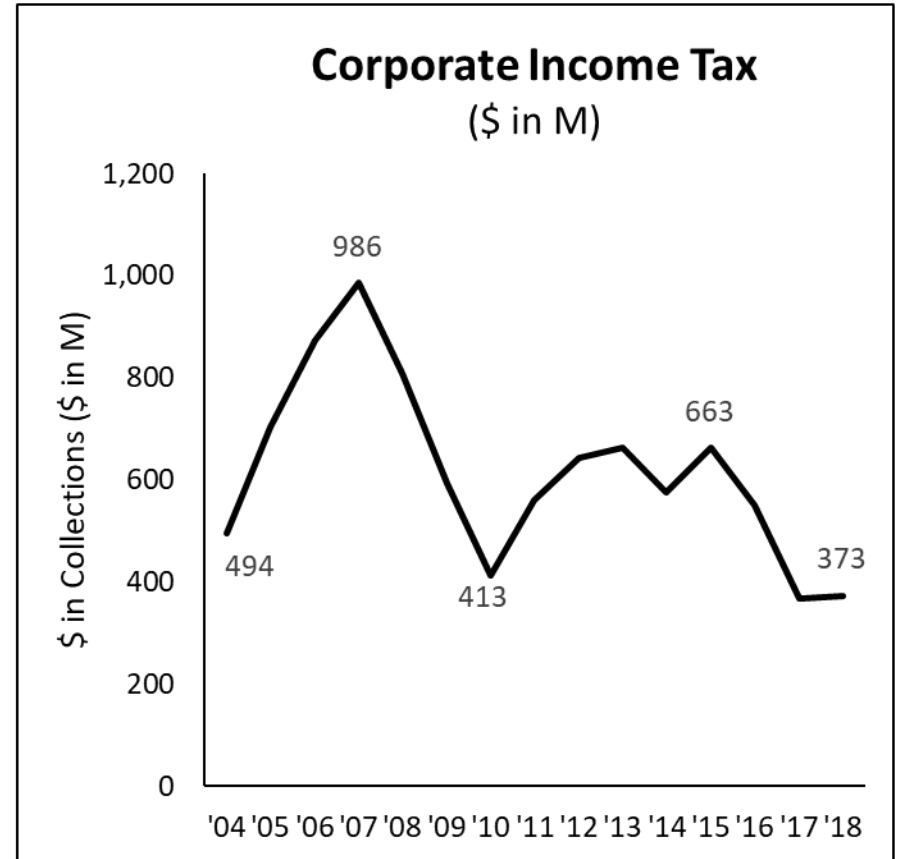
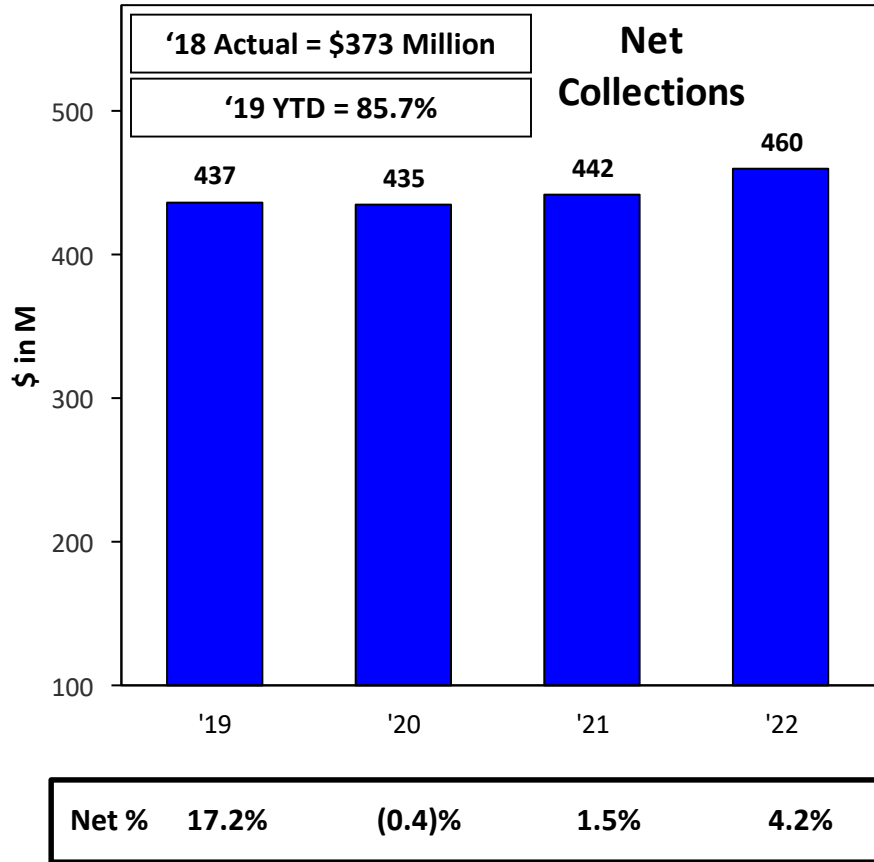
(\$ in M)

Dec 1 - Jan 16

'17	214
'18	393
Enacted Budget Forecast	231
Actual '19 Collections	134

- ❑ IIT payment collections unusually high in '18
- ❑ '19 collections significantly below both '17 and budget forecast levels

Corporate Income Tax



What Is Going On with Corporate Income Tax?

- 86% Year to Date Growth

- ❑ Normally, high correlation between YTD in December and EOY results, but we are in uncharted territory
- ❑ No strong evidence either way on national corporate profitability
- ❑ Arizona corporations could be experiencing unique profitability
- ❑ Corporations may have responded to TCJA by shifting profits into tax year 2018 to take advantage of lower rates

'19 Total Corporate Collections
YTD = \$273 M

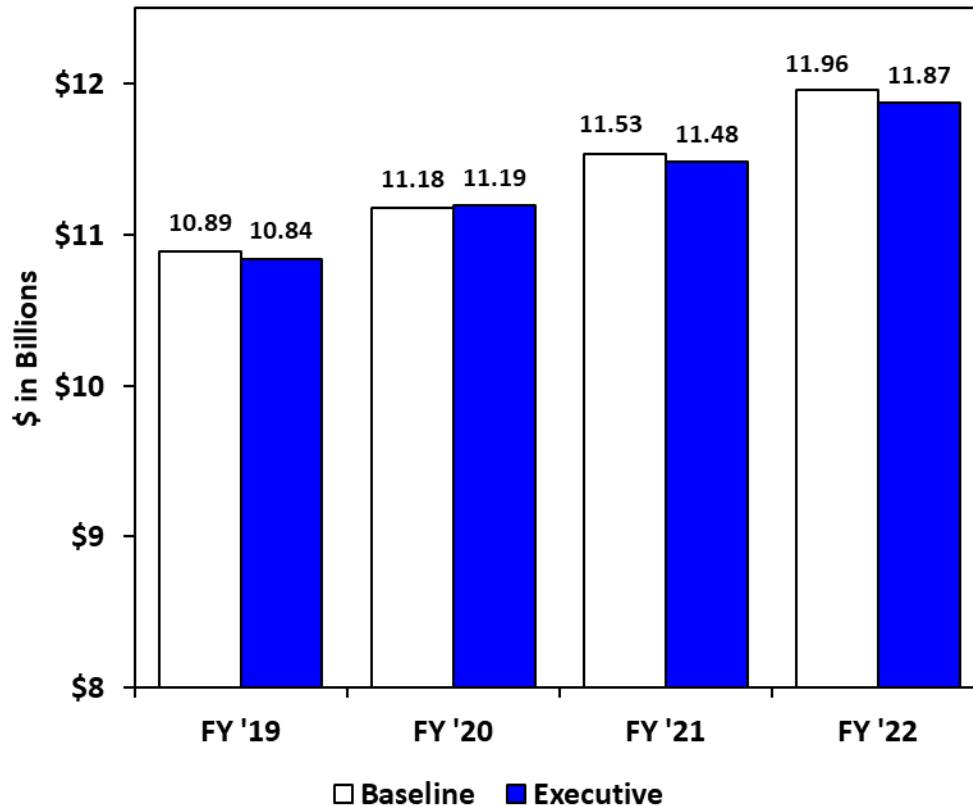
3 Scenarios

	<u>\$ in M</u>
4-Sector Forecast	437
Flat rest of the year	502
Extrapolated	603

JLBC/Executive Have Comparable '20 Risk

- Executive More Cautious in '21/'22

Total Revenue*



Exec Above/(Below) JLBC

(\$ in M)

'19	(47)
'20	14
'21	(43)
'22	(88)
	<hr/>
	(164)

* Excludes Balance Forward

JLBC/Executive Revenue Exclusions

Federal Tax Conformity

- If we conform, state revenues increase by \$133 M to \$236 M (Appendix E)
- Executive supports simple conformity so their proposal has unaccounted revenue

US Supreme Court sports betting ruling allows states to authorize sports betting

Wells Fargo \$37 M Settlement

Another Aspect to Risk: Caseload Forecasting

- Executive Spends Significantly Less over 3 Years

Executive Compared to JLBC

- Lower Medicaid Caseloads
- Lower K-12 Formula
- Higher Unspent \$ Projection

Exec Above/(Below) JLBC	
	<u>(\$ in M)</u>
'20	(52)
'21	(123)
'22	<u>(249)</u>
	(425)

Setting Priorities

'20 – '22 Baseline Spending Projections

- ❑ Baseline is a starting point
- ❑ Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- ❑ Continues \$930 M in K-12 “rollover” payments
- ❑ '19 budget dedicates long-term K-12 spending increases

Projected Baseline Spending Increases by \$390 M

'20 Ongoing Spending Changes	
	<u>\$ in M</u>
ADE – K12 Formula	430
DES – Medicaid Formula	51
AHCCCS – Medicaid Formula	32
Judiciary – Maricopa Judges	7
Sec. of State – Presidential Primary	2
Commerce Authority	(6)
DPS – Highway Fee Shift	(30)
Other	<u>(4)</u>
Total	482

'20 One-Time Spending Deletions *	
	<u>\$ in M</u>
SFB Fewer New Buildings	(2)
SFB Building Repairs (4) **	(34)
DES Prop 206 Costs (2) **	(13)
Counties (3) **	(13)
Universities (3) **	(11)
Employee Health (2) **	(10)
Other	<u>(9)</u>
Total	(92)
* As determined by '19 3-year plan	
** # of years funded	

Total Spending Changes	\$390 M
Total Spending	\$10,784
% Change	3.8%

Ensuring a Structural and Cash Balance

'22 Balances Restrain '20 Level of Initiatives

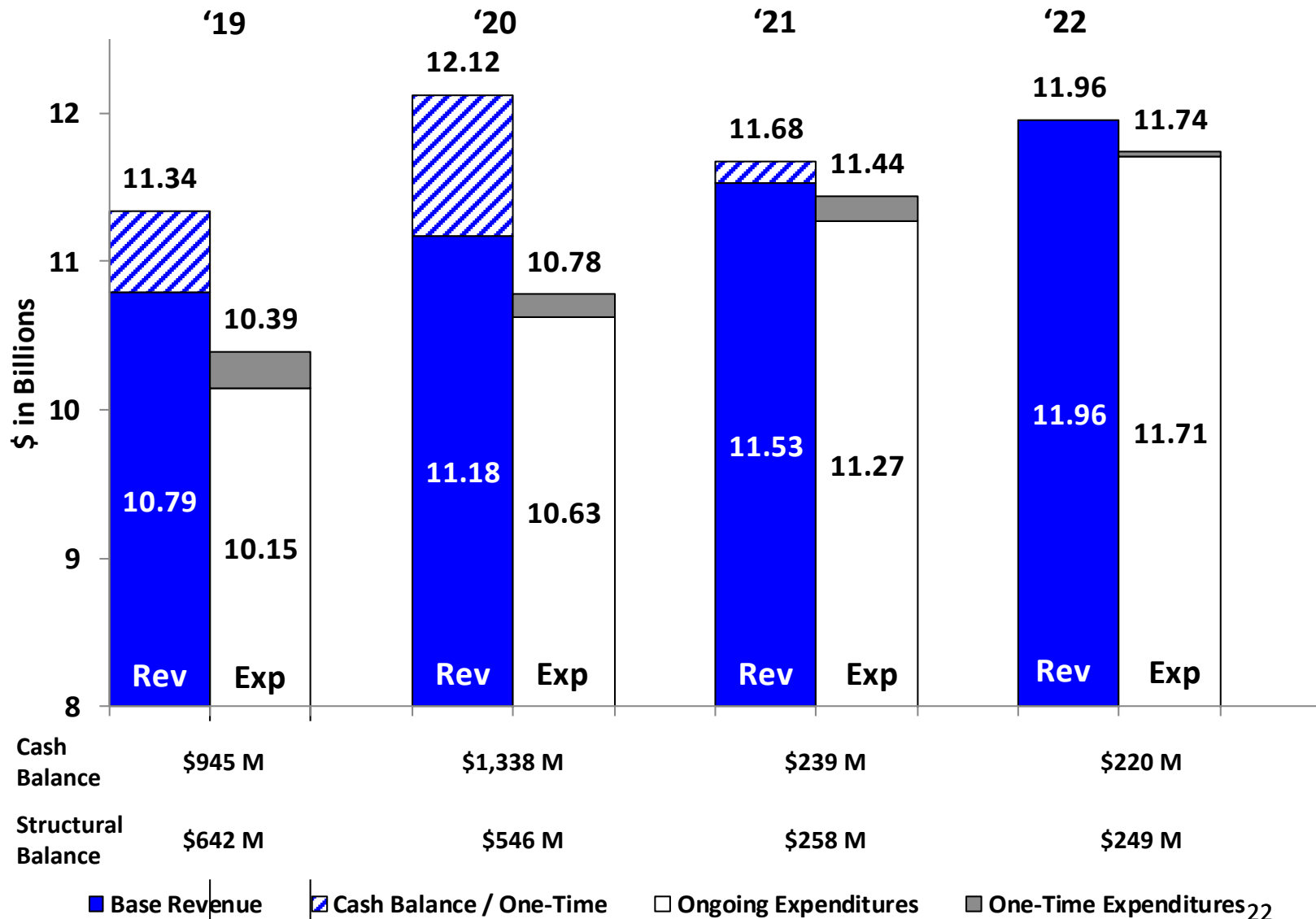
- Excludes \$470 M Rainy Day Fund

	(\$ in M)	
	<u>FY '20</u>	<u>FY '22</u>
Structural Balance	546	249
Cash Balance	1,338	220

- ❑ Structural balance compares ongoing revenues and spending
- ❑ Beyond '20, budget should keep '21 & '22 in balance as well
- ❑ If we permanently commit more than \$200+ M in '20, creates '22 shortfall

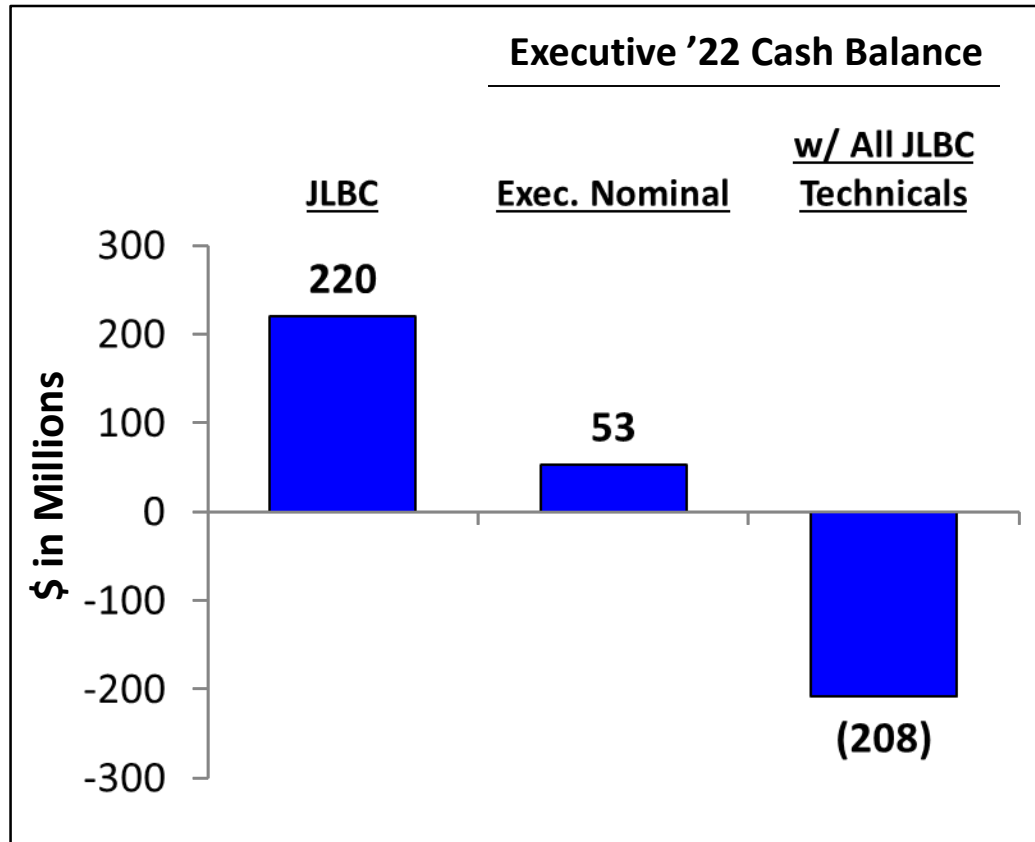
Long Run Budget Permits \$200+ M in Ongoing Initiatives

- Assumes No Discretionary Changes



What if Adjust Executive for JLBC Revenue/Caseloads?

- Causes Shortfall in '22



- ❑ JLBC Caseloads are \$425 M higher through '22
- ❑ JLBC Revenues are \$164 M higher through '22
- ❑ When combine higher revenues and more caseloads, net loss is \$(261) M
- ❑ \$53 M balance becomes \$(208) M shortfall

'19 YTD: 6.8% Growth/\$200 M Above Forecast

- '18 Was \$212 M Above Budget

	<u>% Growth Above Prior Year</u>		<u>'19 +/- Forecast (\$ M)</u>
	<u>'18 Actual</u>	<u>'19 YTD</u>	
Sales	6.2%	7.1%	\$ 85
Individual Income	10.0	0.6	(3)
Corporate Income	1.3	85.7	110
Insurance Premium	1.0	2.6	19
Other	<u>(2.3)</u>	<u>39.4</u>	<u>(11)</u>
Overall *	6.9%	6.8%	\$200

* Revenues exclude beginning balance, fund transfers and Urban Revenue Sharing
YTD = Year to Date through December.

Appendix B: January 2019 4-Sector Forecast

	<u>2019</u>	<u>2020</u>	<u>2021</u>	<u>2022</u>
Sales Tax				
JLBC Forecast	6.0%	4.7%	4.1%	3.8%
UA – Low	5.7%	2.4%	0.4%	3.2%
UA – Base	6.3%	5.1%	4.7%	4.5%
FAC	6.4%	4.9%	3.9%	4.0%
Average:	6.1%	4.3%	3.3%	3.9%
Individual Income Tax				
JLBC Forecast	5.7%	3.8%	3.6%	3.3%
UA – Low	5.9%	4.0%	1.8%	3.1%
UA – Base	6.6%	5.3%	4.9%	4.8%
FAC	8.3%	6.1%	4.2%	5.0%
Average:	6.6%	4.8%	3.6%	4.1%
Corporate Income Tax				
JLBC Forecast	25.0%	-9.8%	2.1%	2.6%
UA – Low	8.8%	1.1%	-0.6%	3.9%
UA – Base	9.1%	3.7%	2.6%	4.7%
FAC	25.8%	4.1%	1.6%	5.3%
Average:	17.2%	-0.4%	1.5%	4.2%
Insurance Premium Tax				
JLBC Forecast	0.5%	1.0%	2.0%	1.3%
UA – Low	0.1%	-0.2%	2.0%	0.6%
UA – Base	0.2%	0.3%	1.9%	1.8%
FAC	-0.1%	1.4%	1.6%	1.5%
Average:	0.2%	0.6%	1.9%	1.3%

JLBC Weighted Average	6.3%	3.5%	3.7%	3.4%
UA Low Weighted Average	5.6%	2.9%	1.1%	3.1%
UA Base Weighted Average	6.2%	4.9%	4.6%	4.5%
FAC Consensus Weighted Average	7.6%	5.2%	3.8%	4.4%
“Big-4” Weighted Average	6.4%	4.2%	3.3%	3.9%
Consensus Weighted Average*	7.0%	3.9%	3.4%	3.8%

* Represents ongoing revenue adjusted for small revenue categories.

Forecasted “Bottom-Line” ‘20 Revenue Growth is 2.6% - Adjusts Consensus Forecast for Transfers & URS

	'19	'20	'21	'22
Net Revenue Growth (7.0%/3.9%/3.4%/3.8%)	750	449	406	464
1-Time Fund Transfers	26	(99)	(2)	0
Urban Revenue Sharing	6	(63)	(55)	(35)
Total	782	287	349	429
% Change	7.7%	2.6%	3.1%	3.7%

Excludes Change in Beginning Balance

Phase-In of \$83 M of Enacted Tax Reductions

	\$ in M*		
	<u>'20</u>	<u>'21</u>	<u>'22</u>
Corporate/IPT School Tuition Indexing	(18)	(21)	(26)
IPT Rate Reduction	(5)	(5)	(5)
Other	(3)	(1)	1
Total	(26)	(27)	(30)

- By '22, revenue base is \$(83) M lower than in '19
- Numbers are incorporated in Net Revenues estimates each year

Federal Tax Code Conformity

The Conformity Issue

- ❑ Starting 1/1/18, federal government cut income taxes by \$1.5 Trillion over 10 years
- ❑ Feds reduced both individual and corporate income rates
- ❑ Offset some of loss with broader base (for example, eliminate/cap deductions)
- ❑ AZ uses income on the federal form as the starting point for our own individual and corporate income tax

How Will Federal Tax Law Changes Affect AZ?

- ❑ When feds change their income definition, AZ has to decide whether to conform in statute
- ❑ Conformity is not automatic – state needs to enact legislation. No legislation enacted yet for TY '18
- ❑ Conformity affects Tax Year 2018 forms
 - DOR makes forms available in January 2019
 - DOR preparing forms assuming conformity

When Are AZ and Federal Taxes Linked?

Linked

No

Tax Rates

- Feds lowered both individual and corporate rates, but no AZ impact

Deductions

Yes/No

- We do not conform to feds' standard & medical deductions
- AZ currently conforms to most others
- Feds have now reduced deductions, which would generate more state revenue

Conformity Is Very Difficult to Estimate

- ❑ Federal legislation includes over 100 provisions, is very complex and is the largest revision in the tax code in 30 years
- ❑ Some provisions can be estimated using AZ-specific data
- ❑ Most provisions, however, require prorating national data
 - Some national estimates are highly speculative
 - AZ's percent share of national estimates further adds to the speculation

How Will Federal Tax Law Changes Affect AZ?

□ If state conforms, FY 2019 impact would be:

	<u>\$ in M</u>
■ JLBC	133
■ DOR (January '18)	236 (50-250)
■ DOR (December '18)	180-200

□ Impact increases by ~\$50 M in '20 under both JLBC and DOR projections

Key Conformity Assumptions

- Continue any current “delinking”
 - Medical expenses
 - Limit bonus depreciation to individual filers. Expanding to corporate filers costs \$68 M
 - No taxation of foreign profits

- JLBC Staff: Discount estimates for safety factor
 - 25% on any prorated federal estimates
 - 10% on DOR model runs (itemized deduction calculations)

Main Conformity Provisions – JLBC Scoring

- Assumes Current Delinking Continues

	<u>\$ in M</u>
<input type="checkbox"/> Cap State & Local Taxes at \$10 K	54
<input type="checkbox"/> Cap Mortgage Interest & limit Home Equity	45
<input type="checkbox"/> Eliminate 2% Business/Employee Expenses	58
<input type="checkbox"/> Repeal Overall Cap on Itemized Deductions	(19)
<input type="checkbox"/> Limit Pass-Through Losses to \$250k/\$500k	32
<input type="checkbox"/> Higher Bonus Depreciation/Business Expensing	(47)
<input type="checkbox"/> Expand Simplified Cash Accounting	(24)
<input type="checkbox"/> Limit Interest Expense Deduction to 30% of Earnings	17
<input type="checkbox"/> Net of All Other	17
Total	133

Individual vs. Business Impact, JLBC Scoring

- Assumes Current Delinking Continues

	<u>\$ in M</u>	
	<u>'19</u>	<u>'20</u>
Individuals	174	183
Businesses	<u>(41)</u>	<u>1</u>
Total	133	184