JLBC Staff - October 2015 Revenue and Budget Update

Summary of the General Fund Budget Outlook

- Fueled by volatile capital gains and corporate receipts, revenues exceeded forecast by $378 million in FY 2015.
- Based on JLBC Staff analysis and input by the Finance Advisory Committee (FAC), $240 million of the $378 million is expected to be available as ongoing revenue.
- In FY 2016 – FY 2019, the 4-sector consensus annual revenue growth rate is between 4% and 5%.
- During the same time, funding formulas would increase annual spending by 1.4% to 2.8%.
- Excluding the Rainy Day Fund reserve, the projected FY 2017 cash balance is $650 million. At the same time, however, ongoing revenues only slightly exceed ongoing spending.
- As a result, dedicating most of the balance to permanent spending increases and/or tax reductions would likely create both a significant cash and structural problem in FY 2018.
- Allocating $250 million to permanent initiatives in FY 2017 could allow the state to maintain a structurally balanced budget in the long run.

The JLBC Staff has also developed a slideshow presentation on this October update which can be found on the JLBC website.

The Caveats

1) The higher-than-expected FY 2015 revenue results again demonstrate the challenge of forecasting collections with any degree of certainty, especially given the unpredictable nature of state, national and international events.

2) Long-term budget forecasts are subject to considerable change -- a 1% projection error over 3 years has a $600 million impact on the ending balance.

3) Estimating the ongoing component of the $378 million FY 2015 revenue overage is speculative. While the current estimate is $240 million, additional data in the next few months could revise that estimate up or down.

4) The 4-sector consensus does not forecast any downturn through FY 2019. If historical averages hold true, a national recession may occur during that time. A recession is typically associated with at least 2 consecutive quarters of decline in the Gross Domestic Product

(GDP), which last occurred in FY 2009. Since 1982, the average length of an expansion is 95 months. If the economy avoids a recession through June 2019, the expansion would be 120 months long.

5) The Baseline spending estimates do not set aside new funding to address any of the state's outstanding litigation. For example, school districts are seeking funding to restore full inflation to the state's K-12 spending formula. Without regard to payments for back years, schools are seeking $336 million in added funding. The state did provide $74 million in "extra" inflation in FY 2016. If this amount is applied to the plaintiffs' claim, the ongoing net cost would be $262 million.

Reporting Requirements

The FY 2016 General Appropriation Act requires JLBC Staff to report by October 15, 2015 as to whether FY 2016's General Fund revenues and ending balance are projected to change by more than $50 million from the budgeted levels. In addition, A.R.S. § 35-125 requires the Legislature to provide 3-year estimates in each year's budget bill. In fulfilling these requirements, JLBC Staff has reviewed the preliminary FY 2015 ending balance estimates and updated its 4-sector revenue projections in conjunction with the October 8th FAC meeting. In addition, JLBC Staff has revised its spending projections through FY 2019 based on current statutory funding formulas.

Updated FY 2015 Estimates

The enacted FY 2015 budget had a projected ending shortfall of $(132) million. The shortfall was to be covered by a $144 million transfer from the Budget Stabilization Fund (BSF).

The FY 2015 ending balance is currently projected at a positive $311 million, thereby eliminating the need for a BSF transfer. The $443 million gain in the ending balance estimates was generated from $378 million in higher revenue and $65 million in lower spending. The Arizona Department of Administration will publish a final FY 2015 ending balance figure by December 1.

Excluding beginning balances, FY 2015 net revenues grew by 6.1% rather than the budgeted increase of 1.6%. The resulting $378 million in revenues above forecast was largely driven by Individual Income and Corporate Income Taxes. AHCCCS was the primary reason for lower-than-expected spending in FY 2015.

Collections were higher than forecast in each of the state's 3 main revenue categories (Sales, Individual Income and Corporate Income Taxes). Of the total forecast overage of $378 million, $219 million was attributable to the Individual Income Tax, $93 million to the Corporate Income Tax, and $64 million to the Sales Tax. *Table 1* displays the performance of these revenue categories as compared to the enacted forecast.

Table 1

FY 2015 Growth Rates and Collections Compared to Enacted Forecast By Revenue Category

	Budgeted	Actual	Above Forecast
Sales	3.1%	4.7%	$64 M
Individual Income	2.3%	8.6%	$219 M
Corporate Income	(0.8)%	15.3%	$93 M

Individual Income Tax

The strong overall 8.6% Individual Income Tax growth is likely due to a surge in April collections from capital gains income. Though final data is not yet available, this explanation is supported by the impressive average stock market growth of 19.2% and 17.5% in 2013 and 2014, respectively.

Additionally, FY 2015 collections from capital gains income may have grown off a "low" FY 2014 base. The potential as well as actual federal tax increases at the beginning of Tax Year 2013 (otherwise known as the "fiscal cliff") incentivized taxpayers to shift income into Tax Year 2012 and out of Tax Year 2013. As a result, the April 2014 final payments associated with Tax Year 2013 may have been lower than normal.

Capital gains collections are the most volatile component of the Individual Income Tax category, making them inherently difficult to forecast. At their peak, General Fund capital gains collections were an estimated $721 million during FY 2006. Subsequently during the Great Recession, these receipts declined by (80)% to a level of $142 million in FY 2010. Since that time, the capital gains revenue category has recovered with double-digit growth in 3 of the last 4 fiscal years.

Corporate Income Tax

The second main contributor to FY 2015's higher revenues is the 15.3% gain in Corporate Income Tax. Collections were $93 million above forecast. The reasons for this gain are difficult to determine without access to timely Corporate Tax return data. Possible explanations range from larger-than-expected corporate profits to less-than-expected use of Corporate Tax credits.

During the 2011 Legislative Session, the state enacted a number of Corporate Tax reductions that are phased in over several years, beginning in Tax Year 2014. While the first-year impact of the phased-in tax reductions was initially expected to occur in FY 2015, later research of Corporate tax-filing behavior strongly suggests that most of the estimated $(72) million first-year revenue loss may not occur until FY 2016.

The uncertainty regarding the FY 2015 results, and the precise timing of future tax law changes, will pose challenges for accurately forecasting Corporate Income Tax revenues during FY 2016.

Because these collections comprised a significant portion of the forecast overage, any evaluation of the ongoing nature of the FY 2015 revenue gains will depend on future Corporate Income Tax results.

Corporate collections have also fluctuated widely over the last decade. These receipts reached $986 million in FY 2007 before losing more than half their value and falling to $413 million in FY 2010. In 9 of the past 10 years, the yearly percent change in Corporate collections was greater than plus or minus 10%.

While some categories posted impressive growth rates, the state's core revenue categories of Sales Tax and Individual Income Tax withholding continue their trend of modest growth. During FY 2015, Sales Tax increased by 4.7%, while withholding grew by 3.4%.

FY 2016 - 1st Quarter

The enacted FY 2016 budget assumed base revenue growth of 3.8%. After adjustments for tax law and one-time changes, the projected annual net revenue growth is 3.6%. Based on preliminary September projections, first quarter FY 2016 revenues are 2.2% above last year. In terms of the main categories, preliminary collections were as follows:

	% Change
• Sales Tax	2.8%
• Individual Income Tax	5.0%
• Corporate Income Tax	(14.4)%

All 3 main categories have declined from their FY 2015 growth rate. Most striking, Corporate collections are down (14.4)% after having increased 15.3% in all of FY 2015. The first quarter Corporate data continues the frequent trend of double digit changes in percent growth from year to year.

Despite the low overall first quarter growth rate, collections are still $64 million above the March enacted budget forecast. While the growth rate is slower than budgeted, the existing revenue base is considerably higher than expected due to the revenue overage in FY 2015.

FY 2016 – FY 2019 Revenue Projections

The FY 2016 – FY 2019 forecast is based on the input from the following 4 sectors (each equally weighted): members of the FAC panel, University of Arizona's "base" and "low" econometric revenue models, and JLBC Staff.

Under the October 4-sector forecast, base General Fund revenues are projected to grow by 4.0% in FY 2016. This rate is slightly higher than the 3.8% rate assumed in the FY 2016 budget. Due to the volatility of the capital gain and Corporate collections, however, the entire FY 2015 revenue base may not be ongoing.

The JLBC Staff surveyed the FAC panelists on the portion of the $378 million FY 2015 revenue gain that may be ongoing. The consensus average was that $240 million of the gain could be categorized in that fashion. As a result, the FY 2016 growth rate has been adjusted downward to 2.6% to back out the one-time FY 2015 gains.

In FY 2017, the projected 4-sector revenue growth rate is 4.0%. The growth rate gradually improves to 4.2% in FY 2018 and 4.6% in FY 2019. Details of the October 2015 4-sector forecast are summarized in *Attachment A*.

In addition to the consensus forecast for base revenues, the budget projections also make adjustments for other factors:

- <u>Elimination of Fund Transfers</u>: The enacted FY 2016 budget included a provision to transfer $100 million from the State Employee Health Insurance Trust Fund (HITF) in FY 2017 due to its overfunded status. This amount is a decline of $(113) million from the $213 million in FY 2016 transfers from a variety of funds. No fund transfers have yet been approved for either FY 2018 or FY 2019.
- <u>Previously Enacted Tax Legislation</u>: Based on prior legislation, $259 million of tax law reductions are being phased in between FY 2017 and FY 2019. These reductions primarily involve the 4-year phase in of a 2% Corporate Income Tax rate reduction and a 100% sales factor option. Both policies were effective as of January 1, 2014. As noted earlier, a large share of the initial impact of the first phase appears to have been delayed until at least October 2015 when most large corporations file extended returns.

Excluding the state's beginning cash balance, total available General Fund revenue is expected to increase from $9.34 billion in FY 2016 to $9.43 billion in FY 2017. The projected FY 2018 and FY 2019 revenue estimates are $9.65 billion and $10.04 billion, respectively.

Future Year Spending Estimates

As part of the October FAC meeting, the JLBC Staff has updated its FY 2016 – FY 2019 Baseline spending estimates. The Baseline reflects the projected spending changes associated with statutory and other active funding formulas.

Overall spending is projected to grow by $150 million in FY 2017 (1.4%), $262 million in FY 2018 (2.8%) and $244 million in FY 2019 (2.6%). These adjustments are comparable to the long term estimates in the enacted FY 2016 budget. With the October update, total General Fund spending is projected to be $9.28 billion in FY 2017, or $(13) million lower than originally forecast in last year's budget.

The estimates incorporate the following specific adjustments:

- K-12 state aid formula growth. In total, K-12 spending is projected to increase by $75 million in FY 2017, $165 million in FY 2018 and $145 million in FY 2019. The growth reflects the following components: 1) 1.4% annual student growth; 2) new annual inflation adjustments, but excluding K-12 litigation inflation costs *(see below)*; and 3) enacted declines in property taxes (via the assessment ratio), which increases K-12 expenses.

The estimates also include a $(70) million reduction in FY 2017 due to policies enacted in the last budget that a) reduce Joint Technological Education District spending and b) eliminate “hold harmless” funding for districts with declining enrollment.

- AHCCCS funding would grow by $81 million net of the transfer of behavioral health spending from the Department of Health Services. This adjustment includes 2.5% population growth, a higher federal match rate and a 1.5% capitation rate growth. The latter factor was mandated by the 3-year spending plan associated with the FY 2016 budget.

- Department of Child Safety (DCS) one-time Backlog funding. The October spending projections conform to the May 2014 Special Session proposal, which reduces the net FY 2017 DCS budget by $(12) million for one-time spending related to an existing backlog of non-active cases. The enacted long-term funding plan channeled another $4 million back into preventive services in FY 2017. While the 2014 Special Session envisioned the elimination of the backlog by FY 2016, the number of cases with no action in 60 days has grown in the last year.

- The Department of Corrections budget would grow by $25 million, primarily for the opening of 1,000 new private beds authorized by the Legislature as part of the FY 2016 budget.

- The updated projections also assume the continued annual suspension of any inactive formulas. Each year, the Legislature enacts certain provisions that serve to only suspend, not repeal, certain statutory formulas. If those inactive formulas were counted in the estimates, spending would increase by approximately $487 million. K-12 accounts for most of the inactive formulas.

K-12 Inflation Litigation

In addition to these Baseline spending changes, the state may face additional costs relating to the K-12 inflation litigation. In July 2014, the Superior Court ruled that the state must “reset” the per pupil formula amount to adjust for full inflation funding that was not provided during FY 2009 – FY 2013. If upheld, this ruling would increase funding by $236 per student.

Based on the latest projections, this reset would translate into increased K-12 spending of: $336 million in FY 2016 and $341 million in FY 2017. The FY 2016 budget included $74 million in “extra” inflation beyond the regular formula requirement. If these monies are counted toward the cost of the reset, the net cost would decline to $262 million.

Future Year Balance Projections

With a $311 million balance from FY 2015, new FY 2016 ongoing revenues of $9.11 billion and other one-time revenues of $228 million, total FY 2016 revenues would be $9.65 billion. After accounting for $9.15 billion in spending, the projected FY 2016 ending balance is $503 million. When the $503 million is combined with $9.33 billion in new FY 2017 revenue and a one-time $100 million transfer from the State Employee Health Insurance Fund, total FY 2017 revenues would be $9.93 billion. With projected spending of $9.28 billion in new FY 2017 spending, the projected FY 2017 balance is $650 million.

If the FY 2016 balance of $503 million is used for any supplemental spending, the FY 2017 balance will decline by a corresponding amount. The JLBC Staff does not currently project any FY 2016 supplemental spending requirements for statutory funding formulas.

While the projected cash balances appear healthy, the state's structural balance is considerably lower. In FY 2015, ongoing revenues fell short of ongoing spending by $(303) million. In FY 2016, the state is still projected to have a structural shortfall, albeit of only $(30) million.

With ongoing revenues of $9.33 billion and ongoing spending of $9.28 billion, the FY 2017 structural balance improves slightly to $47 million. The structural balance further grows in FY 2018 and FY 2019 as projected revenues are expected to exceed statutory funding formula requirements. The projected structural balances for FY 2018 and FY 2019 are $110 million and $250 million, respectively. *(See Table 2 and Attachment B.)*

Table 2

Baseline Ending Balance Projections

	Fiscal Year		
	17	**18**	**19**
Balance Forward/Other	$ 0.60 B	$ 0.00 B	$ 0.00 B
Ongoing Baseline Revenues	9.33 B	9.65 B	10.04 B
Less:			
Ongoing Baseline Spending	(9.28) B	(9.54) B	(9.79) B
Cash Balance	**$650 M***	**$110 M***	**$250 M**
Structural Balance	**$47 M**	**$110 M**	**$250 M**

* The ending balance is presumed allocated as part of the FY 2017 budget process.

Dedicating most of the $650 million cash balance to permanent initiatives in the form of tax reductions and/or spending increases would result in a serious FY 2018 budget problem. For example, all of the balance could be dedicated to new ongoing spending. In that circumstance, ongoing revenues of $9.33 million would be significantly below $9.93 million of ongoing spending. While one-time FY 2017 revenues would be sufficient for a FY 2017 cash balance, there would likely be both a significant structural and cash shortfall in FY 2018.

Allocating $250 million of the $650 million to ongoing initiatives in the FY 2017 budget process may be sustainable. As noted above, the projected Baseline structural balance in FY 2019 is $250 million. The $250 million in new initiatives would draw down the $250 million structural surplus, but it would still result in a structurally balance budget in FY 2019. In the short-term, this scenario would result in FY 2017 and FY 2018 structural shortfalls. The one-time FY 2017 cash balance would be carried forward to ensure a cash balance in those years.

Table 3 outlines this scenario, which also assumes that another $210 million of the FY 2017 cash balance is dedicated to one-time initiatives. Under this scenario, the FY 2019 cash balance is $50 million.

Table 3

$250 Million Scenario - Ending Balance Projections

	Fiscal Year		
	17	**18**	**19**
Balance Forward/Other	$ 0.60 B	$ 0.19 B	$ 0.05 B
Ongoing Baseline Revenues	9.33 B	9.65 B	10.04 B
Less:			
Ongoing Baseline Spending	(9.28) B	(9.54) B	(9.79) B
New Ongoing Initiatives	(0.25) B	(0.25) B	(0.25) B
New One-Time Initiatives	(0.21) B	(0.00) B	(0.00) B
Cash Balance	**$ 190 M**	**$ 50 M**	**$ 50 M**
Structural Balance	**$(203) M**	**$(140) M**	**$ 0 M**

October 8, 2015 FAC 4-Sector Consensus

	FY 2016	FY 2017	FY 2018	FY 2019
Sales Tax				
JLBC Forecast (9/24/2015)	4.0%	4.6%	4.5%	4.4%
UA - Low (9/17/2015)	3.1%	2.3%	3.8%	4.6%
UA - Base (9/17/2015)	4.6%	5.4%	5.9%	5.9%
FAC (9/24/2015)	4.7%	5.0%	4.3%	4.6%
Average:	**4.1%**	**4.3%**	**4.6%**	**4.9%**
Individual Income Tax				
JLBC Forecast (9/24/2015)	4.4%	5.0%	4.5%	4.5%
UA - Low (9/17/2015)	-0.1%	1.1%	3.8%	4.8%
UA - Base (9/17/2015)	2.5%	4.6%	5.5%	5.7%
FAC (9/24/2015)	5.5%	5.1%	4.4%	5.1%
Average:	**3.1%**	**4.0%**	**4.6%**	**5.0%**
Corporate Income Tax				
JLBC Forecast (9/24/2015)	5.5%	4.5%	4.2%	4.0%
UA - Low (9/17/2015)	15.4%	-1.2%	-6.5%	-7.2%
UA - Base (9/17/2015)	16.7%	5.2%	-1.7%	-5.4%
FAC (9/24/2015)	7.7%	6.9%	4.7%	3.7%
Average:	**11.3%**	**3.8%**	**0.1%**	**-1.2%**
JLBC Weighted Average:	**4.3%**	**4.8%**	**4.5%**	**4.4%**
UA Low Weighted Average:	**2.6%**	**1.6%**	**3.2%**	**4.2%**
UA Base Weighted Average:	**4.5%**	**5.0%**	**5.3%**	**5.3%**
FAC Consensus Weighted Average:	**5.3%**	**5.1%**	**4.3%**	**4.8%**
"Big-3" Weighted Average:	**4.2%**	**4.1%**	**4.4%**	**4.7%**
Consensus Weighted Average: *	**4.0%**	**4.0%**	**4.2%**	**4.6%**
Adj. Consensus Weighted Average: **	**3.3%**	**2.8%**	**3.2%**	**3.8%**

* Represents ongoing revenue adjusted for small revenue categories. 4.0% growth estimate in '16 does not include one-time '15 revenue adjustment. With this adjustment included, the ongoing revenue growth estimate would be 2.6%.

** Represents ongoing revenue adjusted for tax law changes; excludes Urban Revenue Sharing

October Finance Advisory Committee
Statement of General Fund Revenues and Expenditures 1/
with One-Time Financing Sources

Attachment B

	FY 2015 Actual	FY 2016 October FAC	FY 2017 October FAC	FY 2018 October FAC	FY 2019 October FAC
REVENUES					
Ongoing Revenues	$9,534,636,100	$9,719,090,100	$10,107,547,700	$10,411,895,400	$10,778,048,700
Previously Enacted Changes			(117,400,000)	(103,400,000)	(73,300,000)
Urban Revenue Sharing	(608,935,700)	(605,634,300)	(663,652,100)	(656,436,800)	(668,715,600)
Net On-going Revenues	$8,925,700,400	$9,113,455,800	$9,326,495,600	$9,652,058,600	$10,036,033,100
One-time Financing Sources					
Balance Forward	$577,399,200	$311,000,000	$503,036,900		
Tax Amnesty		15,000,000			
Fund Transfers	78,123,500	212,941,700	100,000,000		
Subtotal One-time Revenues	$655,522,700	$538,941,700	$603,036,900	$0	$0
Total Revenues	$9,581,223,100	$9,652,397,500	$9,929,532,500	$9,652,058,600	$10,036,033,100
EXPENDITURES					
Operating Budget Appropriations	$9,321,780,500	$9,169,439,300	$9,319,721,300	$9,582,091,600	$9,826,232,800
Supplementals	(27,947,400)	(1,278,700)			
Administrative Adjustments	80,000,000	85,000,000	70,000,000	70,000,000	70,000,000
Revertments	(145,241,100)	(110,000,000)	(110,000,000)	(110,000,000)	(110,000,000)
Subtotal Ongoing Expenditures	$9,228,592,000	$9,143,160,600	$9,279,721,300	$9,542,091,600	$9,786,232,800
One-time Expenditures					
Capital Outlay	$41,631,100	$6,200,000			
Subtotal One-time Expenditures	$41,631,100	$6,200,000	$0	$0	$0
Total Expenditures	$9,270,223,100	$9,149,360,600	$9,279,721,300	$9,542,091,600	$9,786,232,800
Ending Balance 2/	$311,000,000	$503,036,900	$649,811,200 3/	$109,967,000	$249,800,300
Structural Balance 4/	*($302,891,600)*	*($29,704,800)*	*$46,774,300*	*$109,967,000*	*$249,800,300*

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.