FY 2015 BASELINE SUMMARY

Overview

The FY 2015 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.

A.R.S. § 35-125 requires that the General Appropriation Act annually delineate the revenue and expenditure projections for 3 years. The budget, however, would only provide actual appropriations for FY 2015.

In terms of the budget outlook:

- Total FY 2015 General Fund revenue is projected to be $9.36 billion, including $655 million in a FY 2014 year-end balance. Revenues would be $(94) million less than in FY 2014. While the 4-sector consensus base revenues are forecast to grow by $477 million, or 5.3%, the decline in the balance-forward, annualization of prior year tax law changes and the loss of one-time fund transfers offset those gains.
- In comparison, FY 2015 spending is projected to be $9.04 billion. K-12 spending accounts for most of the $234 million, or 2.7%, growth in expenditures, which is limited to current funding formulas and other legal obligations.
- The projected FY 2015 ending balance is $327 million prior to the legislative 2-year Highway User Revenue Fund (HURF) shift proposal. The cash balance would be near $0 in FY 2016, but a $(383) million shortfall would occur in FY 2017.
- There is a legislative proposal to offset the use of HURF for Department of Public Safety (DPS) Highway Patrol expenses in both FY 2015 and FY 2016. The annual General Fund cost of this proposal is $119 million. After adjusting for the HURF proposal, the projected ending balance would be $208 million in FY 2015, $(256) million in FY 2016, and $(383) million in FY 2017.
- Under the current terms of the state's 2010 $1.5 billion debt financing, the state must begin to buy back that debt if its reserves reach a certain level. Based on FY 2015 balances, the required FY 2017 buyback is estimated at $210 million. Unless the Executive revises the buyback terms, the FY 2017 shortfall would become $(593) million.
- These cash balance estimates do not include $460 million in the state's Rainy Day reserve (Budget Stabilization Fund).

Baseline Caveats

- The revenue forecast is based on moderate revenue growth, but assumes that a portion of the FY 2013 capital gain windfall is one-time.
- Over a 3-year period, small percent changes in growth assumptions can have a substantial impact. Eliminating the slow growth scenario in the 4-sector forecast, for example, could increase available revenues by $468 million through FY 2017.
- The impact of pending "budget" lawsuits could be significant. Retroactive K-12 inflation payments have a maximum exposure of $1.26 billion.

Legislative Considerations

- Under the Baseline, a structural shortfall occurs each year. A structural shortfall reflects ongoing spending exceeding ongoing revenue. The $895 million FY 2013 carry-forward, however, keeps the cash budget balanced in the short term.
- As a remnant of the recession, the state annually suspends over $300 million of funding formulas, primarily in K-12 education, and pays $1.2 billion of current year obligations in the next year (the "rollover").
- Among all states, Arizona is tied with several others for the third-lowest credit rating, but the rating agencies' outlook has turned positive. They view elimination of the structural shortfall as a key factor in any possible future rating upgrade.

FY 2014

The FY 2014 ending balance is currently projected to be $655 million, an increase of $407 million over the original budget estimate of $248 million. Total revenues, including the beginning balance, are forecast to be $9.46 billion compared to spending of $8.80 billion. The $403 million revenue adjustment has 3 components:

- An increase of $100 million in ongoing revenues under the updated January consensus forecast.

- An increase of $101 million in the estimate for one-time financing sources, due primarily to the delayed receipt of the national mortgage settlement proceeds and several other smaller one-time sources which were not included in the original FY 2014 budget.
- Increased balance forward from FY 2013. The original budget assumed an ending balance of $694 million for FY 2013. The actual balance carried forward into FY 2014 was $895 million, an increase of $201 million. This increase was due to a combination of both higher than expected revenue collections and lower than expected expenditures in FY 2013.

FY 2013 state revenue collections were affected by both the potential and actual increase in capital gain and dividend taxes at the federal level on January 1, 2013. This factor incentivized taxpayers to take capital gains and businesses to issue dividends in the 4th quarter of calendar 2012 rather than wait until calendar year 2013 or beyond. As a result, income tax collections on these gains were accelerated into FY 2013 from FY 2014 through FY 2016. If this acceleration had not occurred, FY 2014 collections would be higher. Rather than growing by 4.3%, base revenues would be forecast to increase by 5.3%.

FY 2015 Baseline Revenues

While base revenues are forecast to grow in FY 2015, the growth is insufficient to fully offset declines in other sources of revenues. Overall FY 2015 collections would decline to $9.36 billion, or $(94) million below the revised FY 2014 estimate for the following reasons:

- Based on JLBC's 4-sector consensus, FY 2015 base revenues are projected to grow by $477 million, or 5.3%. Base revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing and new tax law changes.
- The state set-aside for urban revenue sharing formula distributions would grow from $561 million to $609 million, thereby reducing state revenue by $(48) million.
- Previously enacted legislative changes would reduce state revenue by $(129) million, primarily from the phase-in of a corporate income tax rate reduction from 6.968% to 4.9%, the phase-in of a change in how multi-state corporations are permitted to treat sales in calculating tax liability ("corporate sales factor"), and a reduction of long term capital gain taxation.
- Discontinuing fund transfers would reduce revenue by $(154) million.
- A $(240) million loss in the balance forward – decreasing from $895 million at the beginning of FY 2014 to $655 million at the start of FY 2015.

The 4-sector estimate was developed using a consensus forecasting process. This consensus equally weights the results of 4 forecasts: *(See the General Fund Revenue section for more information.)*

- The Finance Advisory Committee (FAC), an independent 14-member group of public and private sector economists,
- The University of Arizona Economic and Business Research (EBR) Center's econometric forecasting baseline model,
- The EBR's conservative forecast model, and
- The JLBC Staff forecast.

FY 2015 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2015 Baseline spending is projected to be $9.04 billion, a $234 million, or a 2.7%, increase above FY 2014 prior to any possible HURF shift adjustments. The major adjustments are:

- AHCCCS and Department of Health Services Medicaid spending would increase by $15 million, reflecting modest caseload growth and a 3% capitation rate increase offset by an increase in the federal matching rate. Costs of Medicaid expansion authorized in the FY 2014 budget are primarily offset by a new hospital assessment.
- The Department of Economic Security (DES) budget would also increase by $45 million to backfill one-time federal revenues and for Developmental Disabilities Medicaid growth.
- Department of Education spending would increase by $167 million due to a 1.1% increase in student enrollment, base support level inflation increase of 1.4%, an increase in the state share of homeowner K-12 property taxes, and an offset from new construction property taxes. The increase also includes increases associated with additional district schools converting to charter status and higher cost per pupil for students in the K-12 system.
- University spending would increase by $15 million for continued funding of efforts to achieve the goal of parity between University of Arizona, Arizona State University, and Northern Arizona University per-pupil amounts.

- Department of Corrections spending would increase $25 million to fund legislatively approved prison openings. The cost primarily covers 500 new private medium security prison beds opening on January 1, 2015, annualization of 500 private beds opened on January 1, 2014, and startup costs for 500 state-operated maximum security prison beds anticipated to open on December 1, 2014.

The $9.04 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 49,866 state employees.

There is a legislative proposal to offset the use of HURF for DPS operating expenses in FY 2015 and FY 2016. The 2-year cost of the proposal is $238 million. This proposal could be implemented either by depositing General Fund monies directly into HURF or by eliminating the use of HURF in the DPS budget and backfilling with the General Fund. In either circumstance, net HURF distributions to the Department of Transportation and local governments would increase by $119 million in both years.

JLBC Staff Suggested Process Improvements

Based on its review of agency requests in preparing this Baseline, the JLBC Staff has developed several suggestions to improve legislative oversight and transparency of government spending, including:

- Information Technology (IT) Oversight: Due to the complexity of IT projects, the Legislature has required several large-scale IT projects to procure an independent third-party vendor to provide relevant analysis and ensure adequate oversight before and during implementation. There is, however, no mandatory review requirement. The Baseline includes a statutory change that would require large-scale IT projects with a multi-year cost greater than $5.0 million to obtain a third-party analysis from an independent contracted vendor.
- Improved Tax Analysis: The Baseline includes $1.7 million appropriated to ADOA's Automation Projects Fund for staff and software that would allow the Department of Revenue (DOR) to improve their ability to analyze tax data. The funding would allow DOR to determine the impact of long-term capital gains tax reductions and increase the accuracy and timeliness of reporting income tax credits.
- Increased Budget Transparency: The Baseline would separately delineate the following 3 components of agency budgets to improve understanding of agency spending: 1) delineate Arizona State Hospital resources as part of the Department of Health Services (DHS) budget, 2) dedicate a new line item for DES resources allocated for Child Protective Services in-home preventive services, and 3) separate out components of DES' Long Term Care System Fund and DHS' Intergovernmental Agreements Fund to improve comprehension of budget shifts.
- Arizona School District Charter Conversion Policy: The JLBC Staff recommends the Legislature confirm the current policy for this program while it is in its early stages. By providing an additional $1,000 per student, the program incentivizes districts to convert traditional schools to district-sponsored charters.

Further details on the issues raised here can be found in the relevant agency narrative.

Debt

In FY 2015, the state's projected level of lease-purchase and bonding obligations is $7.7 billion. This amount includes:

- $3.1 billion, state and university office buildings
- $1.8 billion, state highway construction projects
- $1.3 billion, school district projects
- $1.3 billion, state operating debt from FY 2011
- $260 million, Phoenix Convention Center

The associated annual debt service payment is $879 million.

Of the $7.7 billion in total obligations, the General Fund share is $3.0 billion. The General Fund annual debt service is projected to be $364 million in FY 2015.

These obligations exclude the $1.2 billion in current year K-12, University and DES payments that are not paid until the following fiscal year, otherwise known as a "rollover." The $7.7 billion estimate also does not include any unfunded retirement liability.

With both major credit rating agencies, Arizona has the 4th highest rating out of 10 possible levels (Standard & Poor's: AA- and Moody's: Aa3). In comparison to other states, only California and Illinois have a lower rating from both firms. Along with an overall rating, credit agencies also provide an outlook in terms of the future direction of rating changes. Both major agencies have a positive outlook for Arizona, up from "stable" in 2012.

State Operating Debt

The state issued $1.5 billion in tax-exempt debt to finance its FY 2010 operating expenses. This issuance included the sale and leaseback of state office buildings and $450 million in Lottery bonds. *(See the Capital Debt and Lease-Purchase section for more information.)* By FY 2015, the outstanding principal is projected to be $1.3 billion.

Due to federal rules, the terms of the 2010 tax-exempt debt financing require the state to begin a mandatory process of buying back that debt if its post-FY 2014 reserves reach a certain level. The requirements are based on the state's total cash reserve, which is defined by the federal government to consist of: the General Fund balance, the Budget Stabilization Fund (BSF), and monies in certain other minor clearing accounts. In a given fiscal year, the limit on cash reserves is the lesser of the following amounts: 1) A calculation of cash reserves for a fixed 3-year period before the issuance occurred; or 2) 5% of General Fund spending for that fiscal year.

Under the FY 2015 Baseline, plus the Legislative HURF Proposal, the lesser of these amounts is projected to be 5% of General Fund spending, which would leave an estimated cash reserve limit of $458 million. The current projected FY 2015 cash reserve (General Fund balance plus Budget Stabilization Fund balance) is $668 million.

Given that the estimated FY 2015 cash reserve is projected to exceed the limitations under the financing agreements, the state would be required to commence the mandatory buyback process in FY 2017, under the timeline contained in the 2010 financing agreements. Unless the Executive revises these terms, the payment would be the amount that corresponds to the excess cash reserve ($210 million). As a result, the Baseline includes a $210 million one-time expenditure in FY 2017 to reflect the early repayment of the 2010 operating debt, based on the projected FY 2015 ending balance.

The Executive has recently identified an alternative means of complying with federal rules regarding tax exempt issuances. While not currently contained in the 2010 agreements, this alternative would relieve the state of its repayment requirements. The state would instead agree to limit the investment yield on a significant portion of its cash reserves to approximately 4%, which is the interest rate associated with the 2010 operating financing. Moving the state to the yield restriction mechanism would require the Executive to modify the existing financing agreement through a filing with the third party bond trustee. This modification would not require legislative approval.

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 2015 Other Fund appropriated spending level of $3.4 billion, or (3.6)% below FY 2014.

The level of FY 2015 non-appropriated state funds is expected to be $7.6 billion, while non-appropriated Federal Funds are forecasted to be $11.3 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2015 state spending would be $31.3 billion.