FY 2016 BASELINE SUMMARY

Overview

The FY 2016 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 2016.

In terms of the budget outlook:

- Total FY 2016 General Fund revenue is projected to be $8.77 billion. Revenues would be $(440) million less than in FY 2015. While the 4-sector consensus base revenues are forecast to grow by $300 million, or 3.3%, 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 2016 spending is projected to be $9.45 billion. This amount reflects $90 million, or 1.0%, growth in expenditures, which is limited to current funding formulas. K-12 growth of $181 million is offset by declines in one-time information technology, capital, Department of Child Safety spending, and technical adjustments for administrative adjustments and revertments.
- The projected FY 2016 ending balance shortfall is $(678) million prior to any resolution of the K-12 inflation litigation and assuming that the FY 2015 shortfall is solved with one-time measures. The shortfall would increase slightly to $(690) million in FY 2017, then decline to $(581) million in FY 2018.
- The litigation regarding unfunded K-12 inflation could significantly affect the projected shortfall. The additional cost per year to "reset" the Basic State Aid weight at the level sought by the plaintiffs is $337 million in FY 2016, with similar costs in subsequent years. If the state were ultimately required to reset the rate at that level, the FY 2016 shortfall would increase to $(1.02) billion. These figures do not include the impact of back payments for years without the additional inflation payments. The plaintiffs seeking back payments have suggested the state pay an additional $1.26 billion total over a 5-year period.
- The projected FY 2015 ending balance shortfall is now projected to be $(148) million, primarily the result of a decrease in forecasted FY 2015 revenues. This figure does not include additional obligations that might be required pursuant to resolution of the K-12 inflation litigation.
- These cash balance estimates do not include $464 million in the state's Rainy Day reserve (Budget Stabilization Fund).

The Path from a Healthy Surplus to a Large Shortfall

At the end of FY 2013, the state had a balance of $895 million. The following factors lead to the projected FY 2016 shortfall of $(678) million (or $(1.02) billion with the K-12 litigation):

- The state had a $300 million to $400 million underlying structural shortfall in the past several years as ongoing spending exceeded ongoing revenue. These budgets were balanced with one-time monies such as the temporary 1-cent sales tax.
- When the $900 million 1-cent sales tax ended in FY 2013, the FY 2014 budget replaced it with a nearly equivalent carry forward. By the end of FY 2015, however, the carry forward will have been eliminated.
- Lower-than-expected revenue growth.
- Phase-in of tax law changes enacted in 2011 and 2012.
- K-12 inflation litigation.

The current shortfall is not unexpected. The FY 2015 budget was enacted last spring with project shortfalls of $(237) million in FY 2016 and $(489) million in FY 2017.

FY 2015

The FY 2015 ending balance is currently projected to be a shortfall of $(148) million, a decrease of $(278) million from the original budget estimate of a $130 million balance. Total revenues, including the beginning balance, are forecast to be $9.21 billion compared to spending of $9.36 billion. The $(278) million adjustment has 3 components:

- A decrease of $(175) million in ongoing revenues under the updated January consensus forecast, the result of lower-than-budgeted FY 2014 revenues and a decrease in the FY 2015 growth rate from 5.3% to 4.3%.
- Decreased balance forward from FY 2014. The original budget assumed an ending balance of $596 million for FY 2014. The actual balance carried forward into FY 2015 was $577 million, a decrease of $(18) million.
- An increase of $85 million in FY 2015 expenditures, including $36 million for an expected decrease in unspent FY 2015 appropriations, $29 million for higher-than-expected administrative adjustments (expenditures for FY 2014 bills received in FY 2015), and $17 million to reflect the actual timing of capital expenditures delayed from FY 2014. These increases are partially offset by $(7) million of net ex-appropriations.

FY 2016 Baseline Revenues

While base revenues are forecast to grow in FY 2016, the growth is insufficient to fully offset the loss of carry-forward balances and declines in other sources of revenues. Overall FY 2016 collections would decline to $8.77 billion, or $(440) million below the revised FY 2015 estimate for the following reasons:

- Based on JLBC's 4-sector consensus, FY 2016 base revenues are projected to grow by $300 million, or 3.3%. Base revenues reflect the underlying growth in the economy and exclude one-time adjustments, urban revenue sharing and new tax law changes.
- The primary reason for the decline in overall FY 2016 revenues is a $(577) million loss in the balance forward as the FY 2014 carry forward is fully expended in FY 2015.
- The state set-aside for urban revenue sharing formula distributions would decline slightly from $609 million to $606 million, thereby increasing state revenue by $3 million.
- Previously enacted legislative changes would reduce state revenue by $(112) million, primarily from the continued 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 $(54) million.

The 4-sector estimate was developed using a consensus forecasting process. This consensus equally weights the results of 4 forecasts:

- The Finance Advisory Committee (FAC), an independent 13-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.

The FY 2016 growth rate of 3.3% reflects sluggish growth. There are a number of reasons for the slow growth, including:

- Slowdown in housing permits and a decline in construction jobs, which is particularly noticeable amidst growth in the construction sector nationally
- Federal defense contract reductions
- Lingering effects of the "housing bubble" that led to the 2007-2009 recession.

(See the General Fund Revenue section for more information.)

FY 2016 Baseline Spending

Based on statutory funding formulas and other obligations, FY 2016 Baseline spending is projected to be $9.45 billion, a $90 million, or a 1.0%, increase above FY 2015 prior to any potential spending associated with the K-12 inflation litigation. The major adjustments are:

- Department of Education spending would increase by $181 million due to a 1.4% increase in student enrollment, base support level inflation increase of 1.6%, an increase in the state share of homeowner K-12 property taxes, and an offset from new construction property taxes. Since charter school and special education pupils are a larger proportion of student growth (and are more expensive per student), the Baseline includes a higher cost per pupil.
- AHCCCS and Department of Health Services Medicaid spending would increase by $7 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 the hospital assessment.
- The Department of Economic Security (DES) budget would also increase by $22 million for Developmental Disabilities Medicaid growth.
- Department of Corrections spending would increase $8 million to annualize the costs of opening 500 medium-security private beds and 500 maximum-security state-operated beds in the middle of FY 2015. The Baseline excludes funding to address the recent prison health litigation settlement.
- One-time spending for capital, information technology and establishing the Department of Child Safety would not be repeated in FY 2016, reducing spending by $(86) million.

The $9.45 billion spending level would support a Full-Time Equivalent (FTE) Position ceiling of 50,733 state employees.

Forecast Risks

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 $575 million through FY 2018 – these risks could significantly change the final results of these budgets.

The potential gains to the forecast include:

- Improving national economic recovery: The national economy has been improving since the second quarter of 2014. Stronger economic growth, better job prospects, and an increase in consumer confidence could translate into increased net migration to the state, which would also result in more demand for housing and an overall boost to the Arizona economy and related revenue growth.
- The “windfall” from the sharp reduction in gasoline prices: If gas prices remain at the current level for the next 12 months, it could free up an estimated $2 billion for Arizona households. While consumers are likely to save part of this windfall, they will also spend of a portion of their gains. Considering the volatility of energy prices, however, any related windfall in state revenues from such a shift in consumer spending should be regarded as one-time.

The potential losses to the forecast include:

- Uncertainty of international events: As Arizona’s economy has become increasingly tied to the international economy, so has the potential for economic disruptions from global events. Adverse weather events, terrorist actions, and a sluggish worldwide economic situation could dampen the economic recovery nationally and in Arizona.
- Litigation expenses: Beyond the K-12 inflation litigation, the state faces other resolved and potential litigation impacts that have not been incorporated into the Baseline. These impacts include the following:
    - Prison health care settlement (a potential $26 million impact).
    - Higher state employer contribution rates related to retirement litigation (a potential $2 million or $21 million impact, depending on whether higher rates are phased-in).
    - Hospital assessment litigation (a potential minimum impact of $64 million): If the hospital assessment was eliminated, the state would at least have the cost of backfilling the assessment used to fund the mandatory Proposition 204 parents program. The cost would be substantially higher if childless adults were retained on the program.

JLBC Staff Suggested Budget Reforms and 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:

Align Ongoing Revenues and Spending Over Several Years: While the state can operate with a structural shortfall in the short term if it has one-time balances, the current structural shortfall does not significantly shrink in subsequent years. As a result, a fiscal policy goal should be to bring permanent revenues and expenditures into alignment.
Develop Multi-Year Targets and Formalize in General Appropriation Act: The Legislature may not be able to eliminate the structural shortfall in a single year. As a result, the JLBC Staff recommends that the General Appropriation Act include a multi-year plan for resolving budget shortfalls with specific out-year targets.

Dedicate One-Time Revenues for One-Time Spending: The Legislature may want to consider whether to deposit one-time revenues into a new special initiatives fund for one-time purposes. One-time revenues would include higher-than-expected General Fund balances and unusually large income tax collections from capital gains. The latter would require developing a reporting mechanism for "excess" capital gain tax growth so as to permit the deposit of these monies into the one-time special initiatives fund.

While the tax base for most General Fund revenue categories is fairly stable over time, other revenue sources are inherently volatile. For example, it is not unusual for capital gains and corporate income tax to grow at double-digit rates in one year only to be followed by double-digit rate declines in the next year. Such large swings in revenue collections make the budgeting process more difficult. One-time revenue windfalls can also come from non-recurring events such as the recent decline in gas prices. Since energy prices can rise and fall in a short span of time, any revenue windfall associated with such shift in spending patterns is likely to be short-lived.

Voters in California recently approved a ballot measure ("Proposition 2") that requires the state to deposit any "excess" revenue from capital gains taxes into its Rainy Day Fund. In addition, the state would deposit 1.5% of its General Fund revenue into the fund. Half of the fund will remain in reserve while the other half will be used to buy down state debts, including unfunded retirement and operating loans.

Better Tax Reporting: Estimating General Fund revenues is made more difficult by not having current information of tax credit usage. The Baseline includes statutory provisions requiring more timely fiscal year tax credit reporting by the Department of Revenue and insurance premium tax reporting by the Department of Insurance.

Annual Retirement Report: The current budget structure does not give a full picture of retirement expenditures by system, agency, and fund source. The JLBC Staff recommends a new statutory report separately delineating the state's retirement expenses. The JLBC Staff begins this initiative by incorporating a new section, the Consolidated Retirement Report, in the *FY 2016 Baseline Book* which provides this information.

Review of Acute and Behavioral Health Services Integration: AHCCCS and the Department of Health Services have begun to implement smaller scale integration projects. The JLBC Staff suggests that the Legislature evaluate accountability measures as it considers further consolidation of the acute and behavioral health services systems.

In addition to these items which affect overall budget or multiple agencies, the Baseline also includes these agency-specific suggestions:

- Contracted Health Care Rates (Arizona Department of Corrections): The Baseline includes a provision requiring increases in ADC contracted health per diem rates to be reviewed by JLBC, similar to the current process used in the Medicaid program. In the past year, ADC raised contracted health per diem, which may have a budget impact.
- Divisional of Developmental Disabilities (DDD) Budget Transparency (Department of Economic Security): The Baseline separately delineates DDD administrative expenditures to help provide a total budget picture of DDD services. These administrative expenditures had previously been displayed in DES' overall administrative costs.
- 1% Property Tax Cap Subsidy (Arizona Department of Education): The Baseline delineates the state subsidy to local districts which exceed the 1% property tax cap; these costs are currently incorporated into a larger line item. The Arizona Constitution prohibits homeowners from paying more than 1% of their assessed value in primary property taxes from all sources. The Constitution does not specify the solution if a local jurisdiction exceeds 1%, but the state has effectively paid the difference. The projected FY 2016 cost to the state is $28 million.
- Proposition 301 0.6% Sales Tax Planning (Arizona Department of Education): The Proposition 301 sales tax expires after FY 2021. The JLBC Staff recommends that the Legislature begin a planning process to accommodate this expiration.
- Intergovernmental Agreement Funding Transparency (Department of Health Services): The Baseline includes a provision to divide DHS' Intergovernmental Agreements/Interagency Service Agreements Fund into 4 separate funds to ensure that monies are not inappropriately comingled.

- Probation and Automation Transparency (Judiciary): The Baseline shifts funding within the Judiciary's budget in order to better align expenditures with appropriations and bring transparency to how much money the Judiciary transfers to counties for probation activities and how much money the Judiciary spends on other activities.
- Local K-12 Bonding Report (School Facilities Board): The Baseline includes a provision requiring SFB to report annually on capital bond approvals by school districts to provide a better understanding of bond issuances and school construction occurring outside of state funding.
- University Tuition Collections: Tuition collections are split between appropriated and non-appropriated amounts. To increase transparency, the JLBC Staff recommends that tuition collections either be fully appropriated or fully non-appropriated.
- Displaying Rio Nuevo Expenditures (Revenues): The Baseline shifts the display of Rio Nuevo expenditures from being an offset to General Fund revenue to being an operating budget expenditure, increasing transparency and conforming its display with that of the Phoenix Civic Center payment.

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

Debt

In FY 2016, the state's projected level of lease-purchase and bonding obligations is $7.5 billion. This amount includes:

- $3.2 billion, state and university office buildings
- $1.7 billion, state highway construction projects
- $1.1 billion, school district projects
- $1.2 billion, state operating debt from FY 2011
- $260 million, Phoenix Convention Center

The associated annual debt service payment is $913 million.

Of the $7.5 billion in total obligations, the General Fund share is $2.8 billion. The General Fund annual debt service is projected to be $365 million in FY 2016.

As a remnant of the Great Recession, the state pays $1.2 billion of current year obligations in the next year (the "rollover"). The $7.5 billion estimate of total obligations also does not include any unfunded retirement liability.

With both major credit rating agencies, Arizona has the fourth highest rating out of 10 possible levels (Standard & Poor's: AA- and Moody's: Aa3). In comparison to other states, Arizona is tied for fourth worst, with only New Jersey, California and Illinois having 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; while the rating is positive, that outlook was released a year ago.

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 2016 Other Fund appropriated spending level of $3.5 billion, or (0.8)% below FY 2015.

The level of FY 2016 non-appropriated state funds is expected to be $8.0 billion, while non-appropriated Federal Funds are forecast to be $12.3 billion. When all appropriated and non-appropriated fund sources are combined, total FY 2016 state spending would be $33.2 billion.