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# **FY 2018 JLBC Baseline**

## **Full Version**

**January 13, 2017**

**JLBC**

# '18 JLBC Baseline is Nominally Balanced

## - But Several Factors Will Likely Eliminate Available \$

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- ❑ Baseline compares revenues with funding formula requirements to provide a guideline of available resources
- ❑ Both net revenues and spending are nearly flat compared to '17
- ❑ '18 Baseline cash balance is \$159 M, and the structural balance is \$46 M
- ❑ Even before new initiatives are discussed, the retention of some one-time '17 spending and minimum wage requirements could eliminate the surplus funds.

# Baseline Eliminates \$240 M in 1-Time Spending

## - Legislative Interest in Retaining Some of These Funds?

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<u>Possible Retention Candidates</u>	<u>\$ in M</u>
<input type="checkbox"/> ADE IT System	7
<input type="checkbox"/> ADE Statutory Expirations	50
<input type="checkbox"/> SFB Building Grants	15
<input type="checkbox"/> Universities	19
<input type="checkbox"/> County Assistance (HURF / DJC Offset)	38
<b>Total</b>	<b>130</b>

# Proposition 206 Minimum Wage Costs

## - Affects State's Contracted Providers

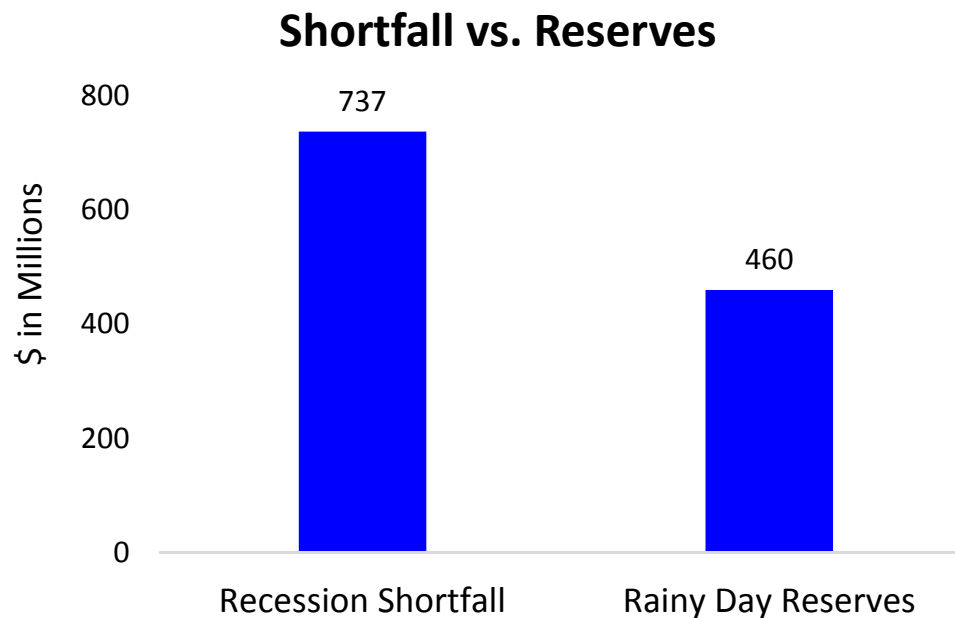
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- ❑ The state has raised rates for Medicaid Long-Term Care providers at a cost of \$23 M
- ❑ Cost is based on a simplifying set of assumptions, not known wages
- ❑ We are researching other impacts, such as K-12, Universities, DCS, and DES
- ❑ Combined, possible one-time retention candidates and the Long-Term Care minimum wage would cost \$153 M
- ❑ If these items were funded ongoing, the \$46 M structural balance would become a \$(107) M shortfall

# Budgets Should Also Be “Stress Tested”

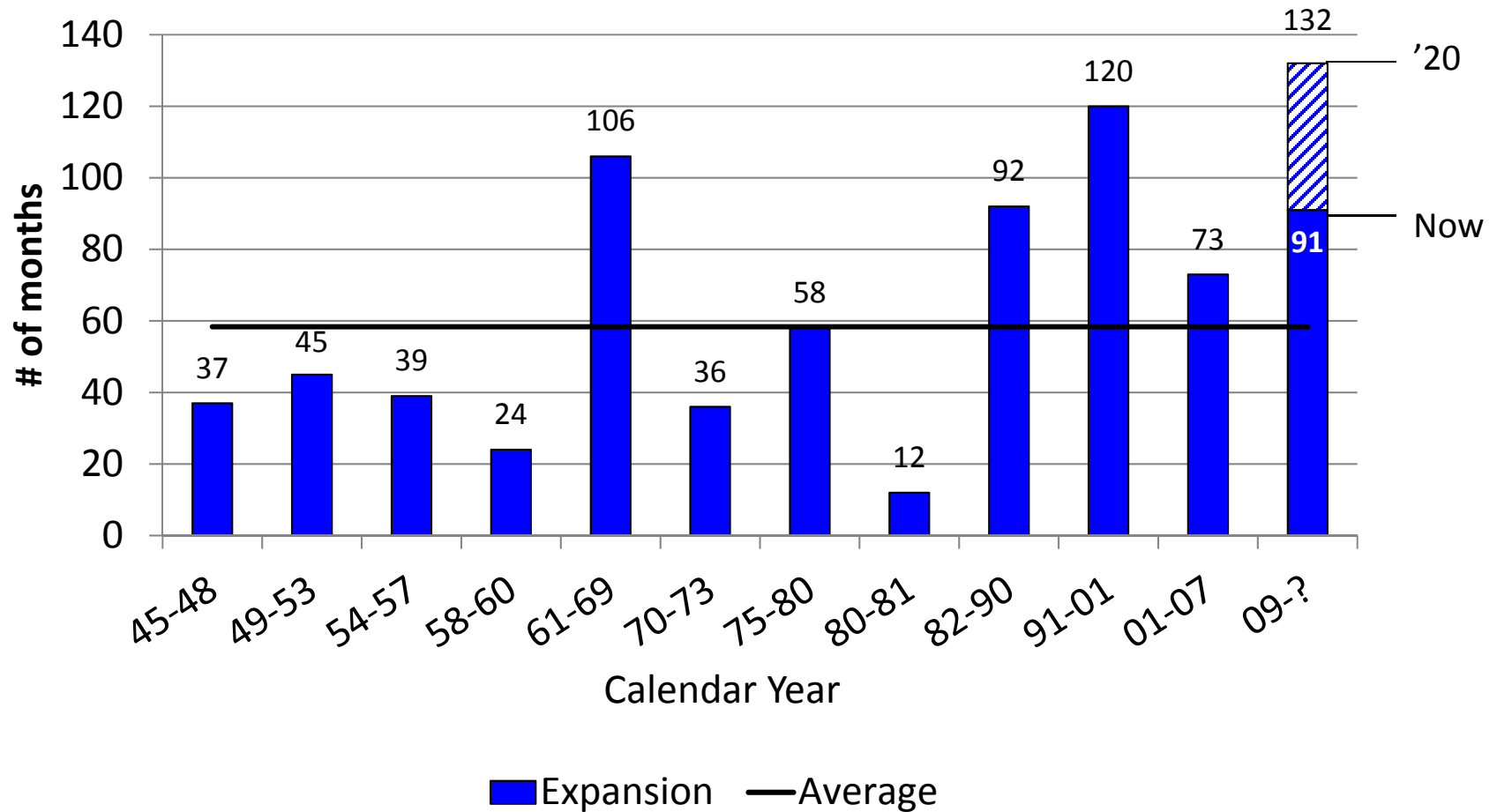
## - Evaluates Level of Reserves in a Recession

- While Base Revenue would grow 3.9% in '18 Baseline, in stress test revenues decline (5)%
- \$(737) M Shortfall under stress test



# Current Expansion Reaching Record Length

## Length of US Economic Expansions



Expansion: time period without 2 consecutive quarters of GDP decline

# Revenue Forecast Uncertainties

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- Department of Revenue Staffing
  - Unknown impact of 1/3rd reduction in DOR collections/audit staff
  - Forecast has not been specifically adjusted, but staff reduction may have affected FAC panelists' estimates
  - DOR hopes to offset loss of staff with greater e-filing, but impact unlikely to be immediate
  
- Federal Fiscal and Monetary Policy
  - New tax reductions and infrastructure spending likely to stimulate the economy
  - If federal deficit grows, interest rates could rise and offset the fiscal policy stimulus
  - Federal Reserve will need to chart a course on interest rates as events unfold

# Arizona Has Other Fiscal Challenges

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- ❑ Federal changes to Affordable Care Act could cost between \$100 M and \$1.4 B
  - Unknown start date; could be deferred to '19
  
- ❑ Pending Litigation Against the State
  - Hospital Assessment (\$100 M - \$250 M)
  - Rental Care Surcharge (\$150 M)
  
- ❑ Retirement System Underfunding
  - '18 employer rates do not reflect the cost of the AZ Supreme Court's decision in the Hall case
  - The Elected Official System is underfunded by approximately \$30 M



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# **Revenue Overview**

# Arizona's Budget Picture Better than Most

## - Numerous States Have Budget Problems

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	<u># of States</u>
<input type="checkbox"/> Reduced the Enacted Budget Mid-Year	17
<input type="checkbox"/> Revenues Below Budgeted Forecast	25
<input type="checkbox"/> Balance Less than 5%	14
<input type="checkbox"/> Declining Balances	28*

\*Arizona was only in the “Declining Balances” category

# Arizona Ranks 14<sup>th</sup> in Economic Momentum

- State Policy Reports – Joint NGA/NCSL Project

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	<u>AZ Rate</u>	<u>AZ Rank</u>
<input type="checkbox"/> Change in Personal Income (Sept)	3.8%	18
<input type="checkbox"/> Change in Population (July)	1.7%	8
<input type="checkbox"/> Change in Employment (Nov)	1.1%	29
<input type="checkbox"/> Unemployment Rate (Nov)	5.0%	32

# '17 YTD Continues Slow '16 Revenue Growth

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	<u>'16 Actual</u>	<u>'17 YTD</u>
Sales	2.9%	3.1%
Individual Income	5.5%	3.6%
Corporate Income	(13.9)%	(24.0)%
Insurance Premium	9.1%	28.2%
Other	12.2%	16.5%
Overall	<u>3.5%</u>	<u>3.0%</u>

- Includes preliminary December estimates
- Revenues exclude fund transfers and urban revenue sharing
- Through December, year-to-date revenues \$37 M above forecast

# How Does JLBC Forecast Revenues?

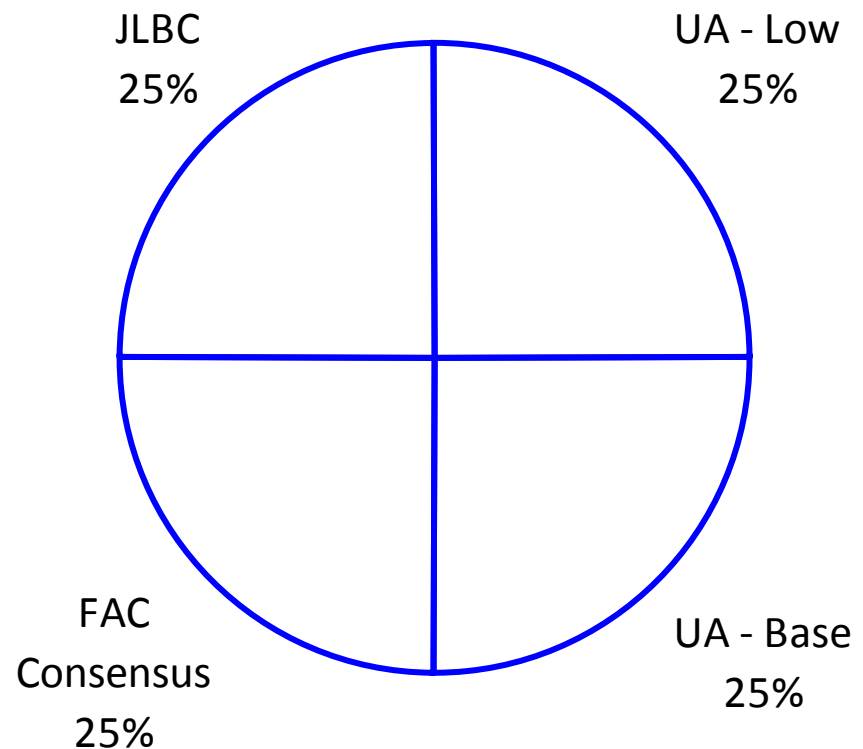
## - Four-Sector Consensus Forecast

4-sector forecast equally weights:

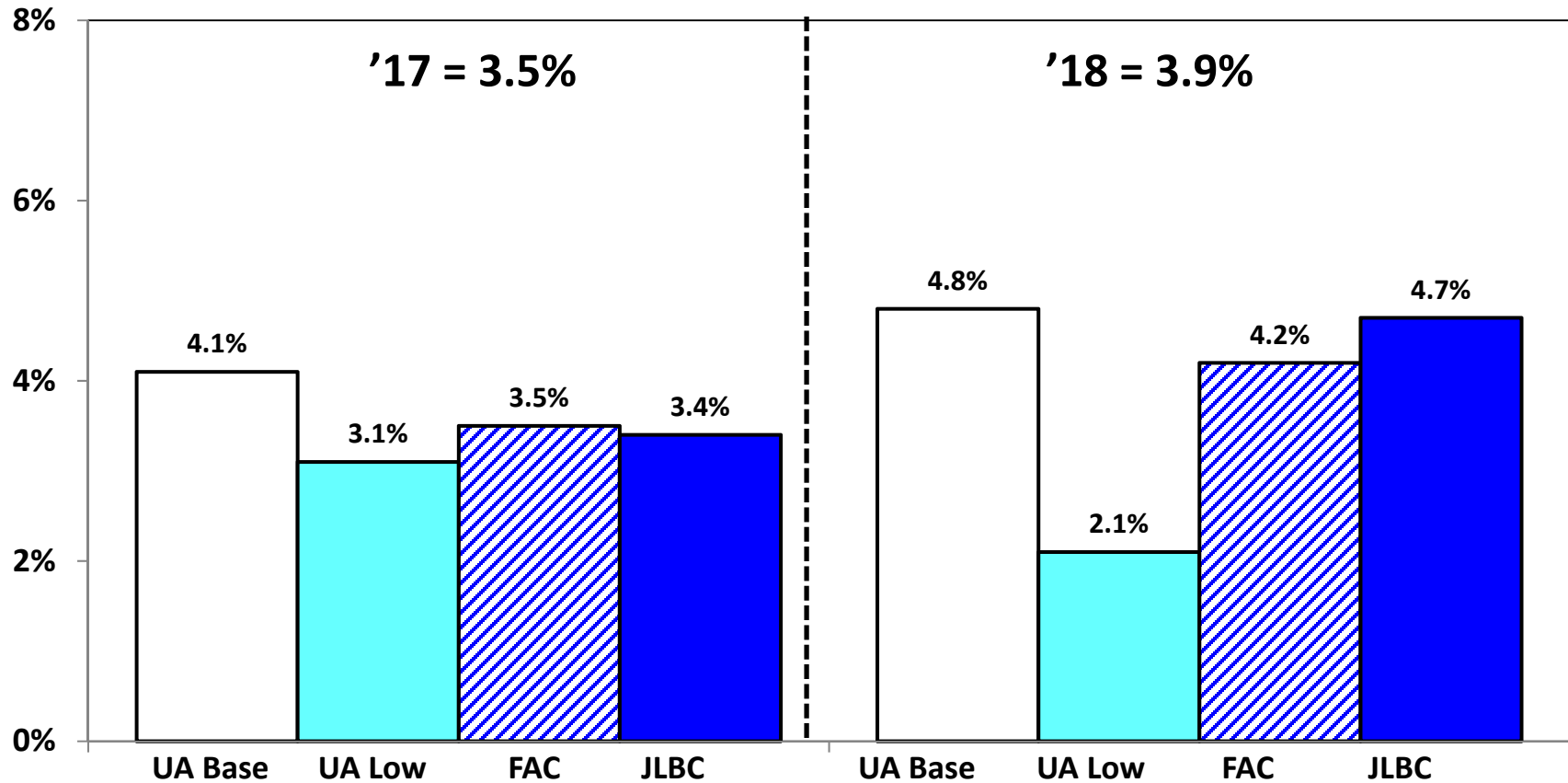
- FAC average
- UofA model – base
- UofA model – low
- JLBC Staff forecast

Model Includes:

- Sales Tax
- Individual Income Tax
- Corporate Income Tax
- Insurance Premium Tax
- Remaining revenues (5% of total) are staff forecast



# 4-Sector Base Growth is 3.5% in '17 & 3.9% in '18



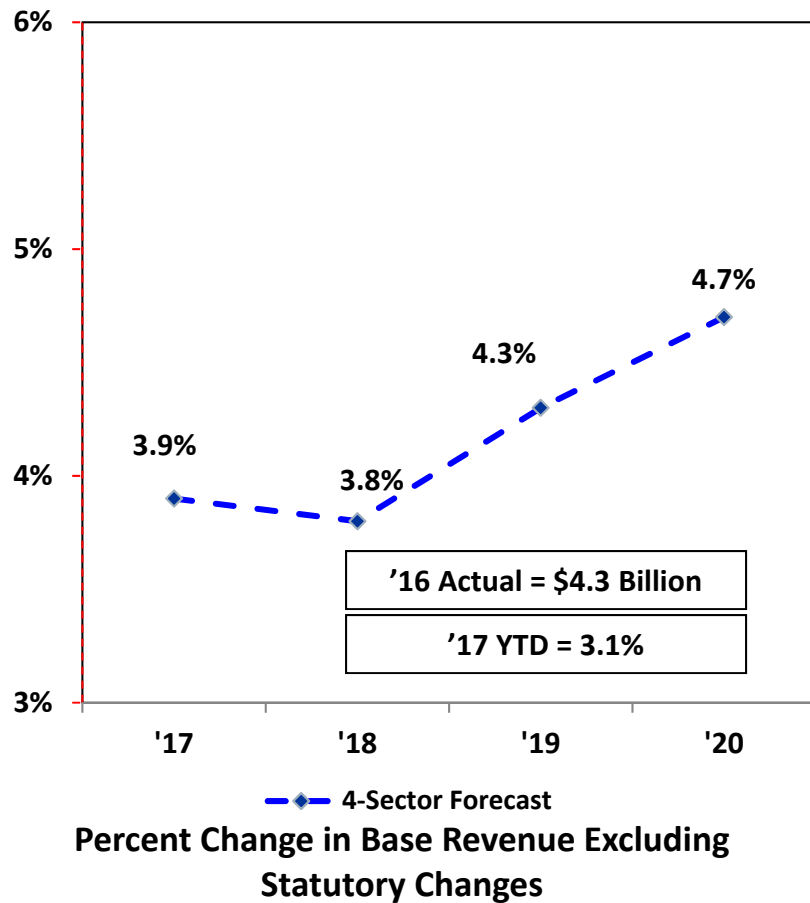
Details in Appendix A

Prior to adjusting for small tax categories, the Big 4 base growth rate is 3.6% in '17 and 4.0% in '18



# Sales Tax

- Projected Growth of 3.9% in '17 and 3.8% in '18



Consumers are more cautious after the Great Recession:

## Sales Tax Growth

	<u>AZ</u>	<u>US</u>
Pre-Recession	7.5%	4.8%
Post-Recession	3.0%	3.4%

# '17 YTD Sales Tax Growth by Category

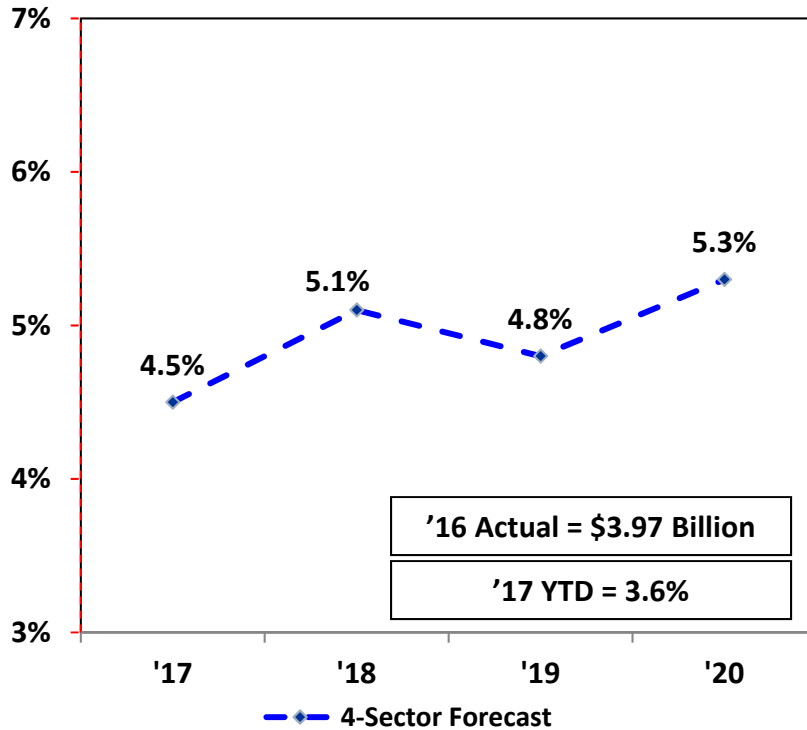
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	'17 Growth by Category*	
Retail	3.5%	<ul style="list-style-type: none"> <li>❑ If current trend continues, retail growth on track to be the slowest since '10</li> </ul>
Contracting	3.1%	
Use	-0.9%	<ul style="list-style-type: none"> <li>❑ Although contracting has reached its “reset,” growth remains weak</li> </ul>
Restaurant/Bar	8.4%	
Utilities	-0.6%	
Other	<u>-0.1%</u>	<ul style="list-style-type: none"> <li>❑ Restaurant and bar sales only strong category</li> </ul>
Total	2.8%	



# Individual Income Tax

- Projected Growth of 4.5% in '17 and 5.1% in '18

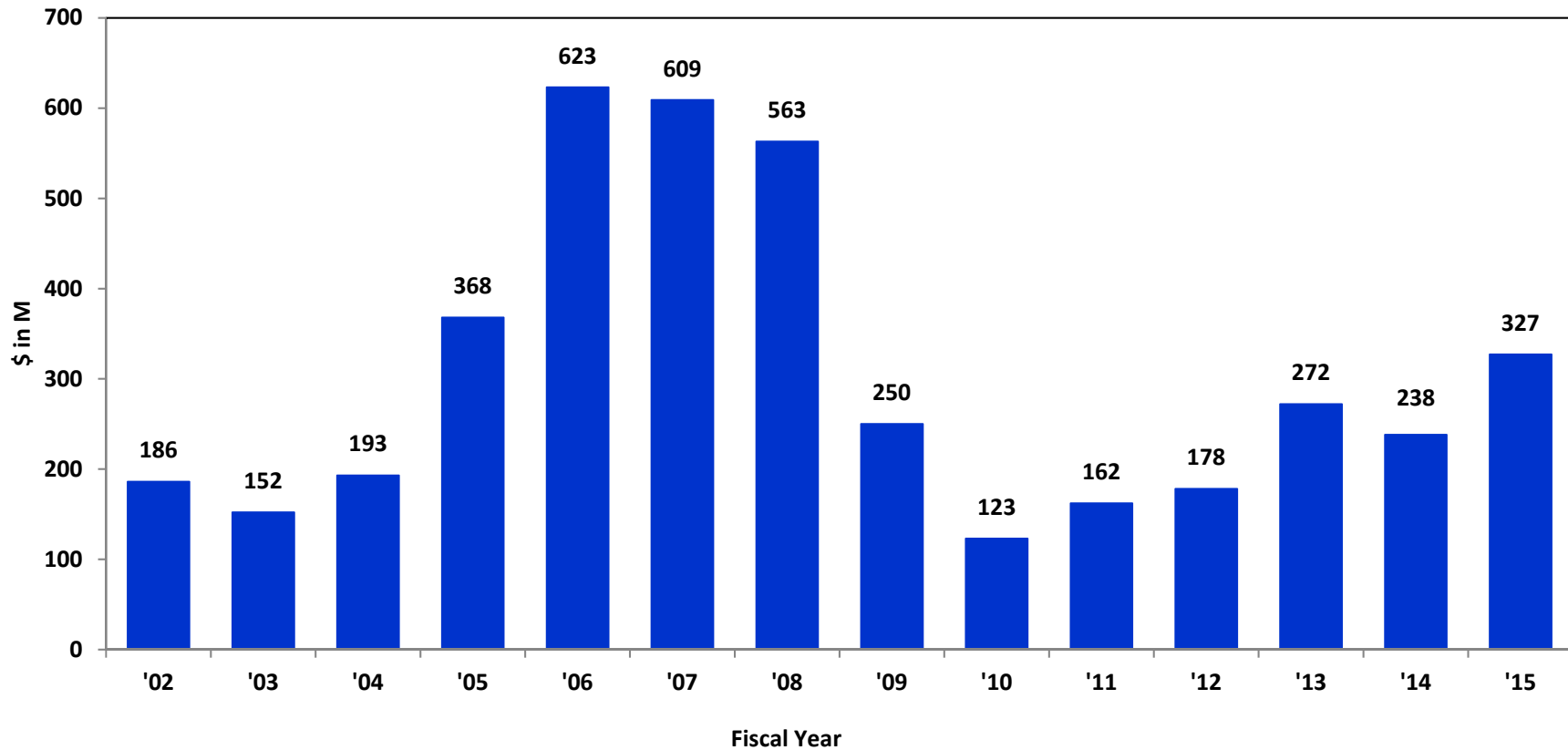


Percent Change in Base Revenue Excluding Statutory Changes

	'16	YTD '17
Withholding	4.0%	6.0%
Payments	8.9%	(5.7)%
Refunds	4.6%	8.6%
Total	5.5%	3.6%

- ❑ After technical change, '17 withholding growing 4.7%—highest since '11
- ❑ Since employment only up 2.1%, withholding may reflect wage increases

# Volatility of Capital Gains Complicates Forecasting

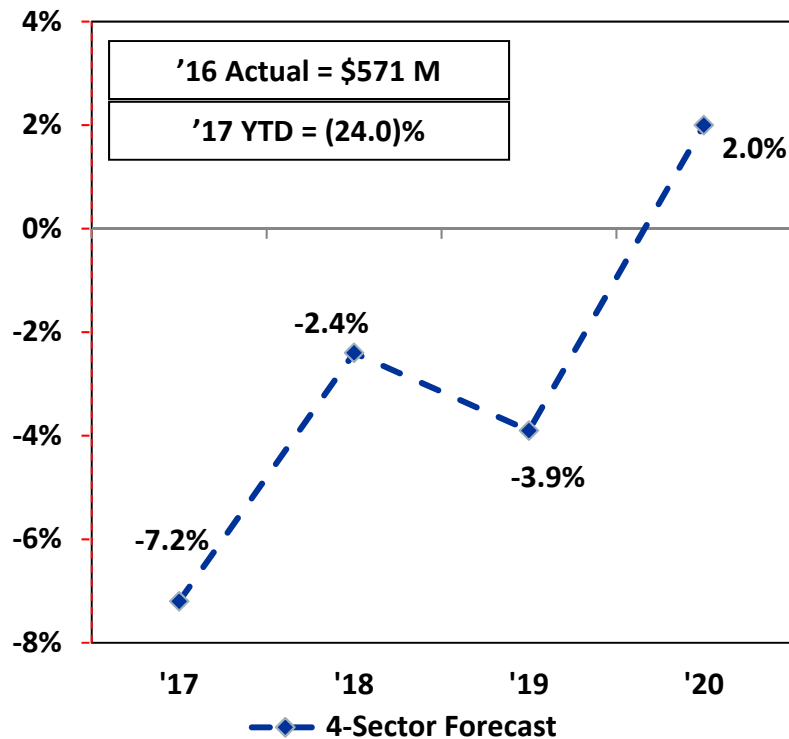


**Individual Income Tax Capital Gains Revenue**

'14 and '15 Not Adjusted for Tax Law Changes

# Corporate Income Tax

- Projected Decline of (7.2)% in '17 and (2.4)% in '18

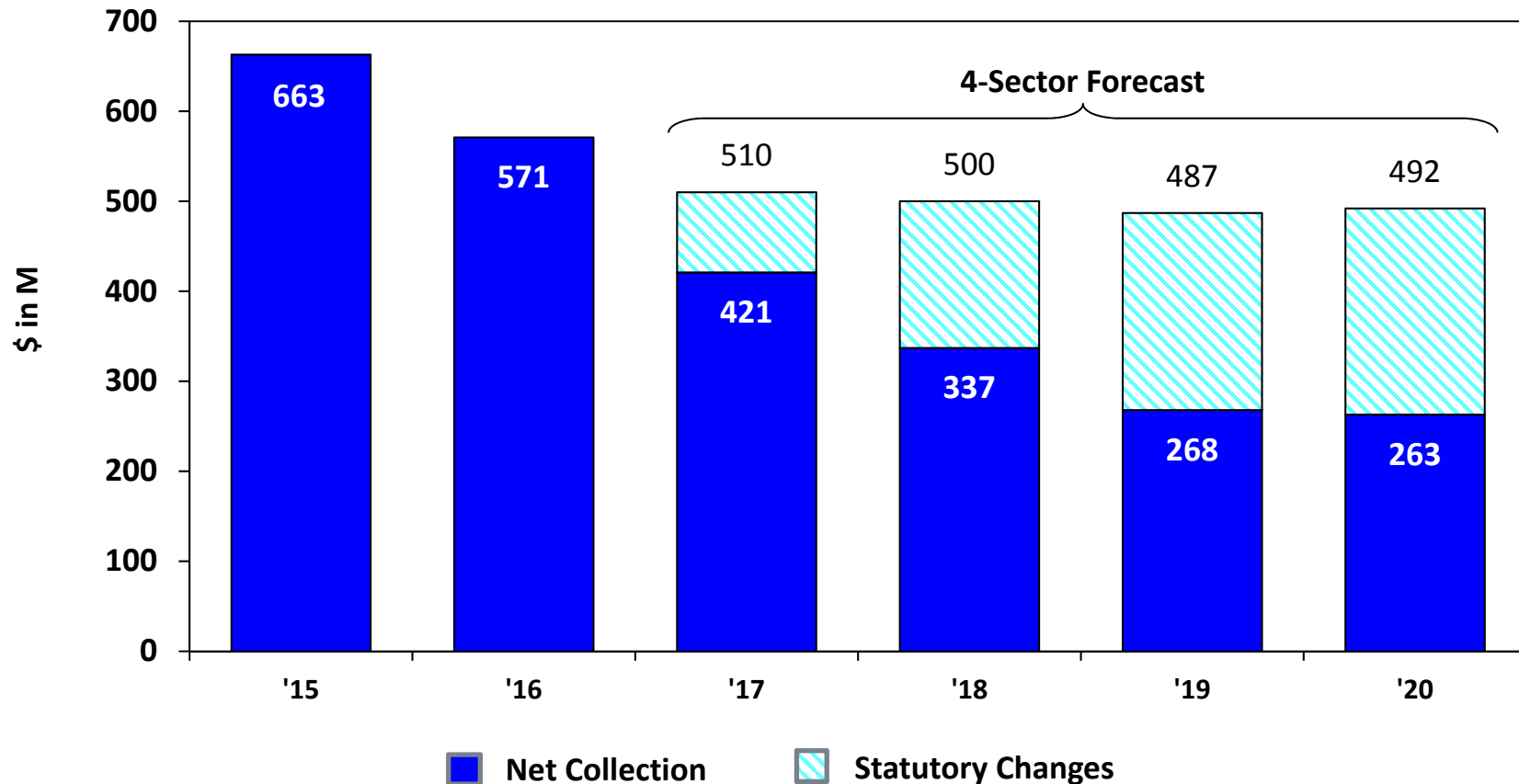


Percent Change in Base Revenue Excluding Statutory Changes

- Base Revenue is to reflect corporate collections prior to tax reductions
- 3-year decline of (14)% seems pessimistic
- Panelists may be pricing in impact of fewer DOR auditors

# '20 CIT Projected to be \$263 M

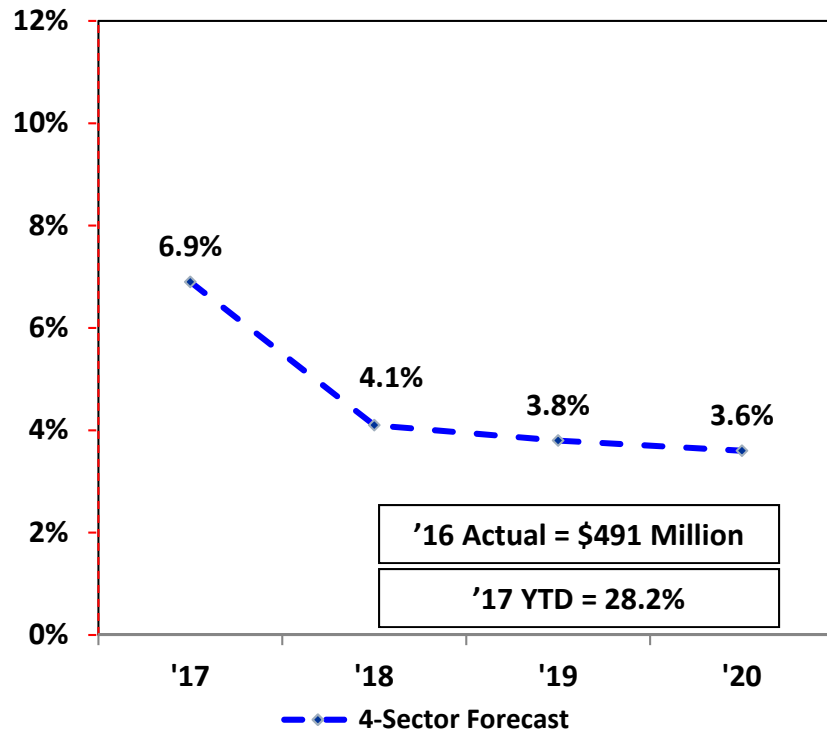
- Primary Reductions are 2% Rate Cut and 100% Sales Factor



Given taxpayer confidentiality, timing of tax reductions highly uncertain

# Insurance Premium Tax

- Projected Growth of 6.9% in '17 and 4.1% in '18

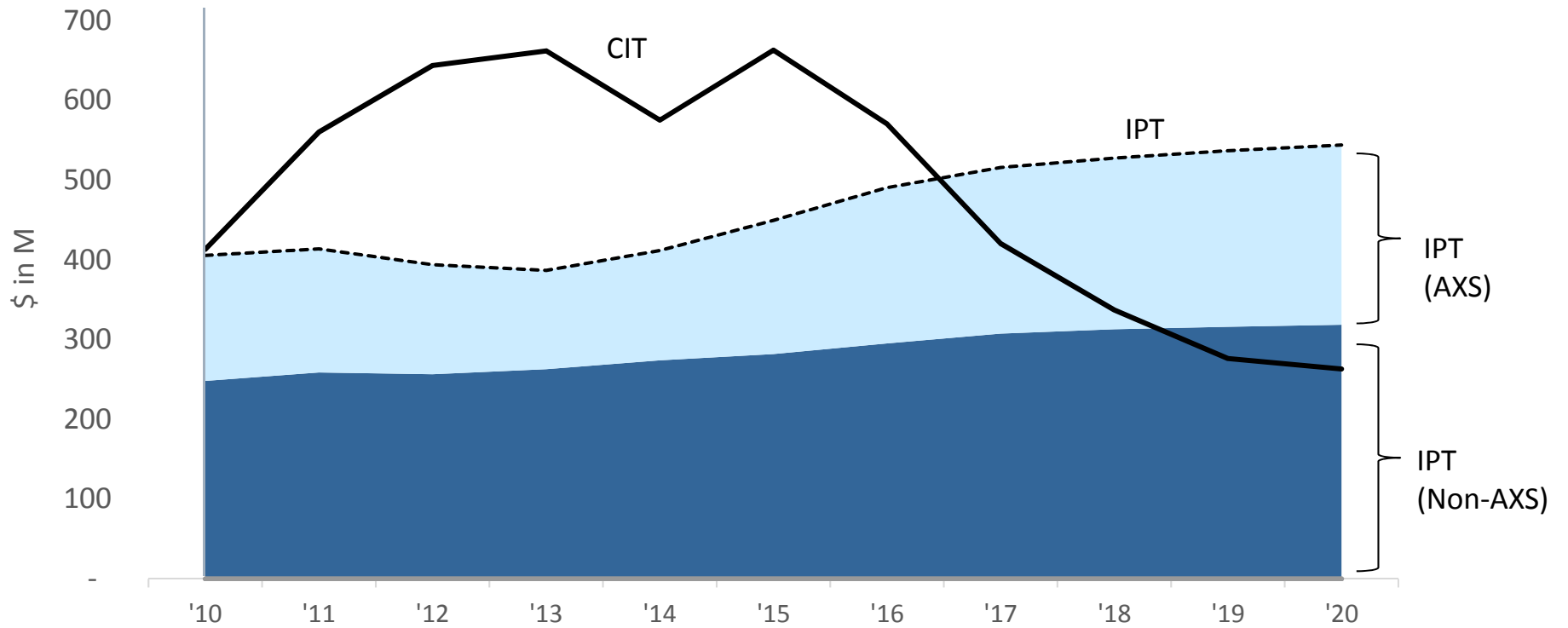


Percent Change in Base Revenue Excluding Statutory Changes

- ❑ IPT (\$516 M) expected to exceed CIT (\$421 M) in '17
- ❑ As a result, IPT is now included in FAC and UA forecasts
- ❑ 27% growth in last 3 years — aided by AHCCCS expansion
- ❑ Federal AHCCCS expansion driving recent year increases
- ❑ 28.2% YTD growth impacted by timing issues
- ❑ Changing the Affordable Care Act could impact collections

# Insurance Taxes Surpassing Corporate Taxes

## - AHCCCS-Related Premiums Built into Federal Reimbursement



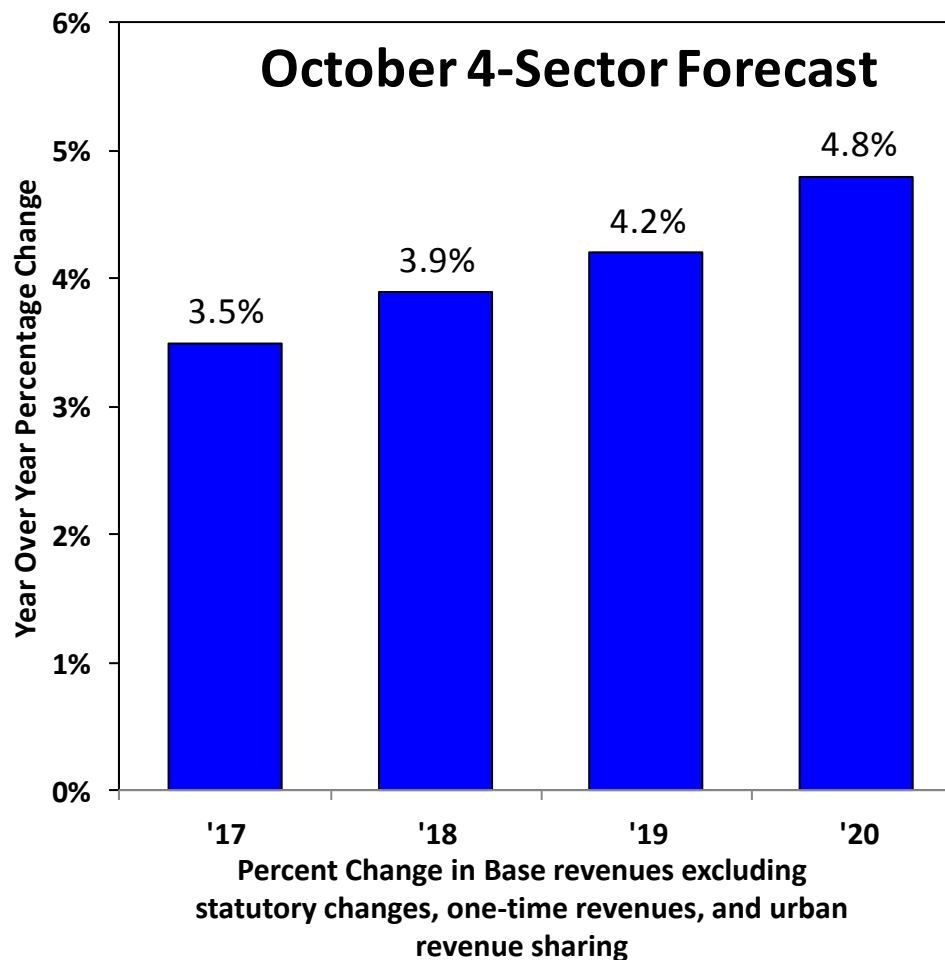
# Growth Accelerates Through '20

Chance of Exceeding Forecast

60%

Long Run Average Growth

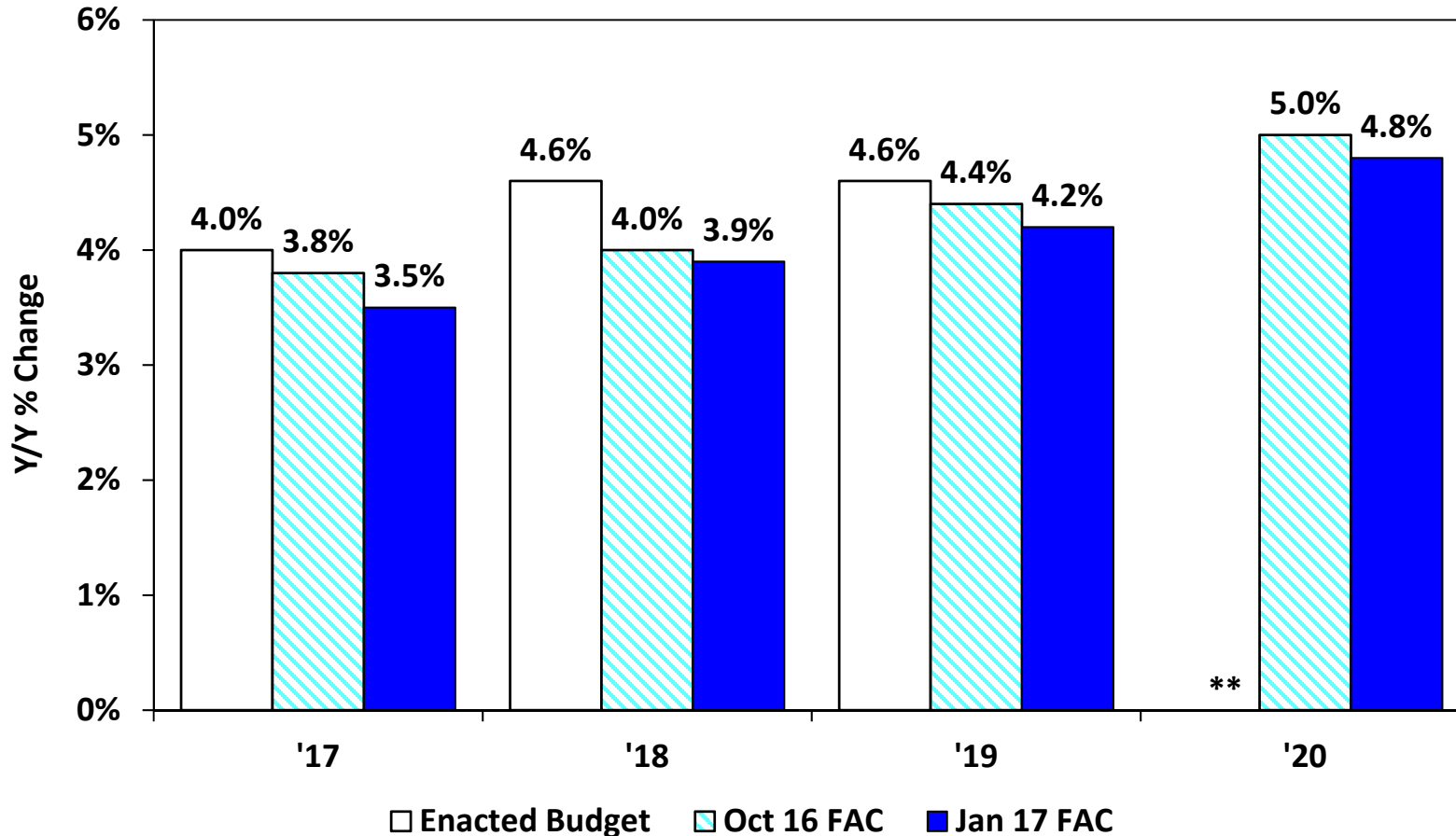
4.6%



Details in Appendix A

# Forecast of Revenue Growth is Slowing

Base Revenue Growth Rate \*



\*Excludes one-time revenues, tax law changes, and urban revenue sharing

\*\* Enacted '17 budget did not include a '20 estimate



# Adjustments Reduce Growth Rate to 0.2% in '18

	\$ in M		
	<u>'18</u>	<u>'19</u>	<u>'20</u>
Base Revenue Growth (3.9%/4.2%/4.8%)	394	430	508
One-Time Fund Transfers	(79)	0	0
Previously Enacted Tax Legislation	(107)	(66)	(23)
Urban Revenue Sharing	(17)	(0)	(18)
Beginning Balance Reduction	(170)	(114)	0
<b>Total Revenue Changes</b>	<u>21</u>	<u>250</u>	<u>467</u>
<b>Total Revenue</b>	<b>\$9,761</b>	<b>\$10,011</b>	<b>\$10,478</b>
<b>% Change</b>	<b>0.2%</b>	<b>2.6%</b>	<b>4.7%</b>

# Phase-In of \$196 M of Enacted Tax Reductions

	\$ in M*		
	<u>'18</u>	<u>'19</u>	<u>'20</u>
Corporate Rate Reduction/Sales Factor	(62)	(43)	(0)
Corporate/IPT School Tuition Indexing	(12)	(15)	(18)
Bonus Depreciation Full Conformity	(8)	(0)	(0)
Expiring R&D Credit Enhancement	0	3	8
Manufacturing Electricity Exemption	(12)	(0)	(0)
Other	<u>(13)</u>	<u>(11)</u>	<u>(13)</u>
<b>Total</b>	<b><u>(107)</u></b>	<b><u>(66)</u></b>	<b><u>(23)</u></b>

\*By '20, revenue base is \$(196) M lower than in '17

# Current State of Tax Credit Policy

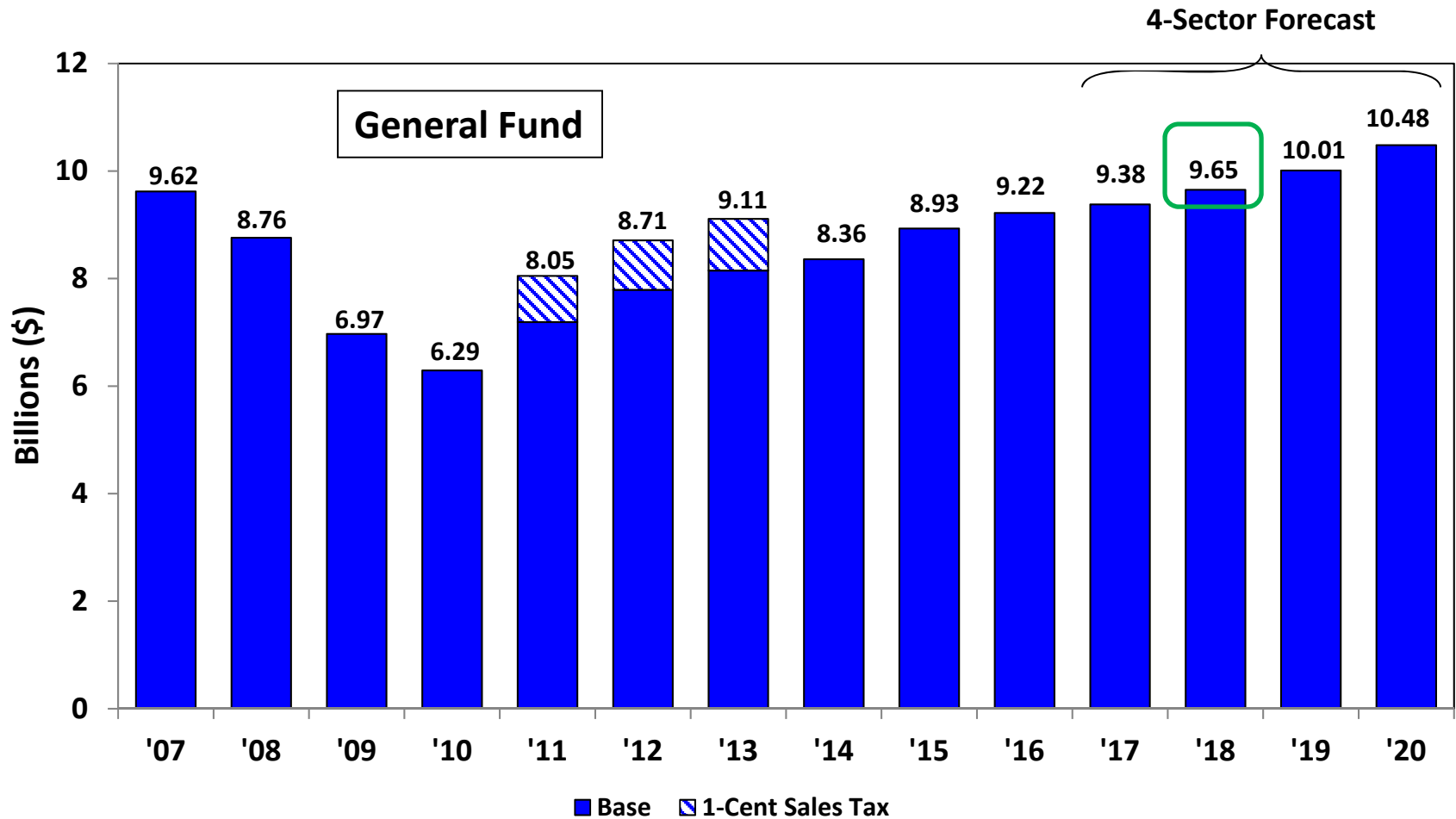
## - '16 Actual Credits Taken

\$ in M

<u>Credit</u>	<u>IIT</u>	<u>CIT</u>	<u>IPT</u>
School Tuition Organizations	99	30	26
Public School Extracurricular	46	0	0
Research & Development	12	97	0
Charitable Organizations	37	0	0
Renewable Energy / Solar	5	10	0
New Employment	0	5	4
Other	16	6	4
<b>Total</b>	<b>215*</b>	<b>148</b>	<b>34</b>

\*Excludes \$148 M for IIT paid to other states and \$32 M for Prop 301 credit

# Forecast Reaches Pre-Recession Level in '18



Excludes balance forward and other one-time revenues. Includes tax law changes and urban revenue sharing.

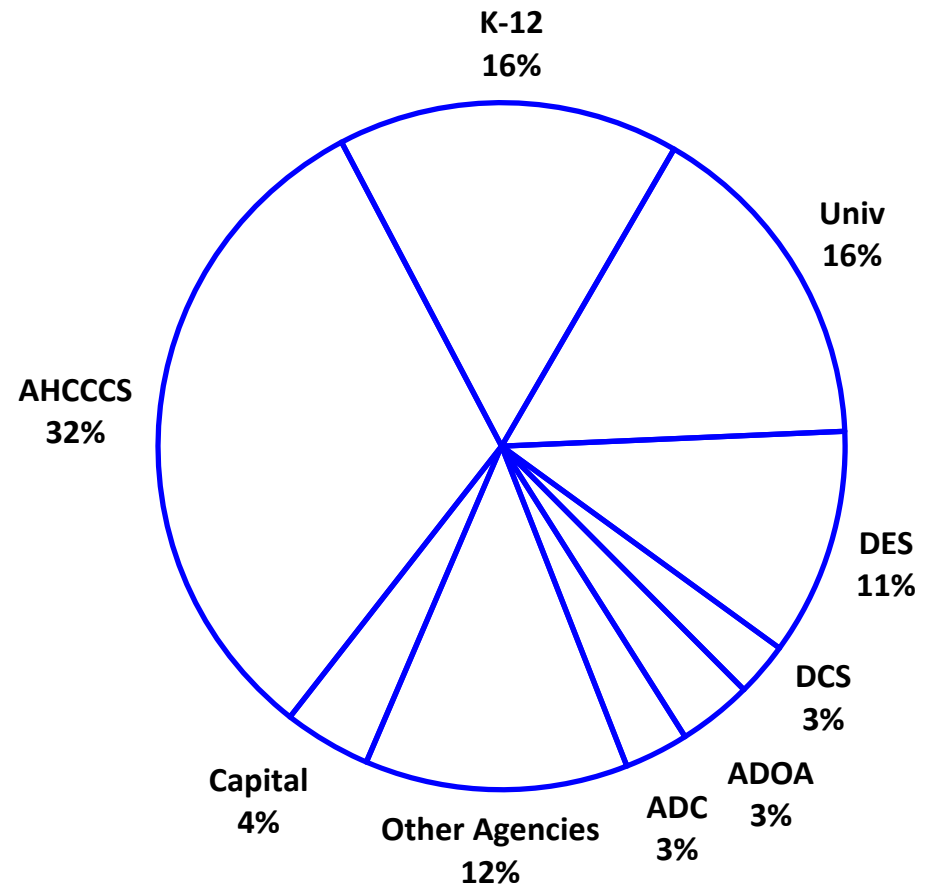
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# Spending Overview

# '18 Baseline Total Spending is \$38.3 Billion

## - General and Non-General Fund

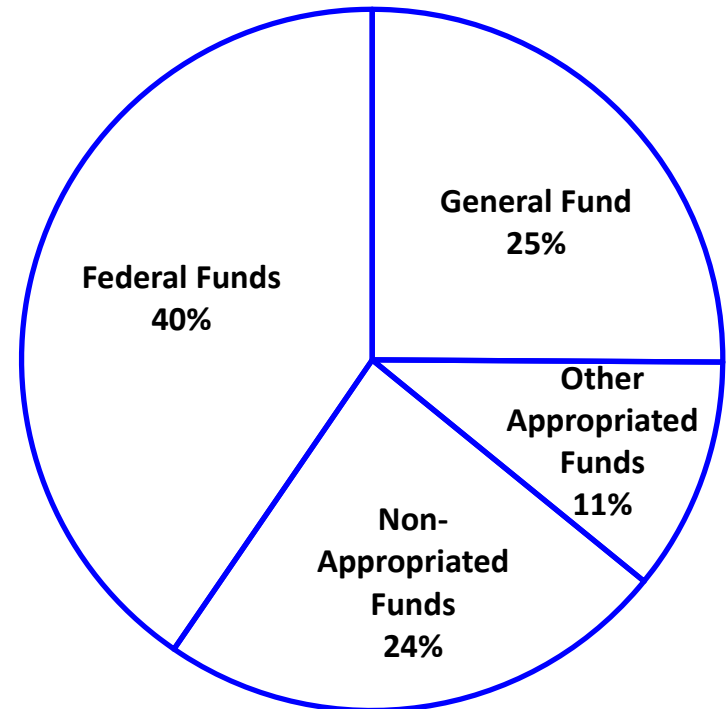
<u>Budget Unit</u>	<u>\$ in Millions</u>
AHCCCS	12,163.3
Education (K-12)	6,165.8
Universities	6,107.1
Economic Security	4,098.8
ADOA	1,339.1
Corrections	1,159.2
DCS	972.6
Other Agencies/Distributions	4,744.9
Capital	1,579.5
<b>TOTAL</b>	<b>38,330.2</b>



# The \$9.6 B General Fund Share is 25% of Total Funds

## - GF Share Down from 43% in '02

<u>'18 Baseline Fund Source</u>	<u>\$ in Millions</u>
General Fund	9,621.6
Other Appropriated Funds	4,130.8
Non-Appropriated Funds	9,078.2
Federal Funds	15,499.7
<b>TOTAL</b>	<b>\$38,330.2</b>



# '17 – '20 Baseline Spending Projections

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- ❑ Baseline reflects changes to active statutory and other funding formulas - no discretionary additions
- ❑ Continues annual suspension of \$493 M of inactive formulas (including \$372 M for K-12)
- ❑ Continues \$931 M in K-12 “rollover” payments
- ❑ Assumes spending classified as one-time or expiring in '17 budget does not continue



# Projected Baseline Spending Changes

## - '18 Statutory Spending Offset By Elimination Of 1-Times

	\$ in M Above Prior Year		
	<u>'18</u>	<u>'19</u>	<u>'20</u>
ADE – K-12 Formula	79	135	168
AHCCCS – Medicaid Formula	44	109	143
DES – Medicaid Formula	18	27	30
Corrections — Annualize Bed Cost	7	1	2
Universities — Eliminate 1-Time \$	(15)	0	(3)
DCS	0	0	0
SFB — Building Renewal	(16)	(34)	34
DPS – Border Task Force Equipment	(15)	0	0
Counties – Cost Sharing Offset / HURF	(38)	0	0
Capital - \$8 M ADOA/\$10 M Vets Home	(18)	0	0
Capital – ADOT Highway Projects	(57)	0	0
Other	<u>(15)</u>	<u>4</u>	<u>0</u>
<b>Total Spending Changes</b>	<b>(25)</b>	<b>241</b>	<b>374</b>
<b>Total Spending</b>	<b>\$9,602</b>	<b>\$9,843</b>	<b>\$10,217</b>
<b>% Change</b>	<b>-0.3%</b>	<b>2.5%</b>	<b>3.8%</b>

# Main Caseload Assumptions

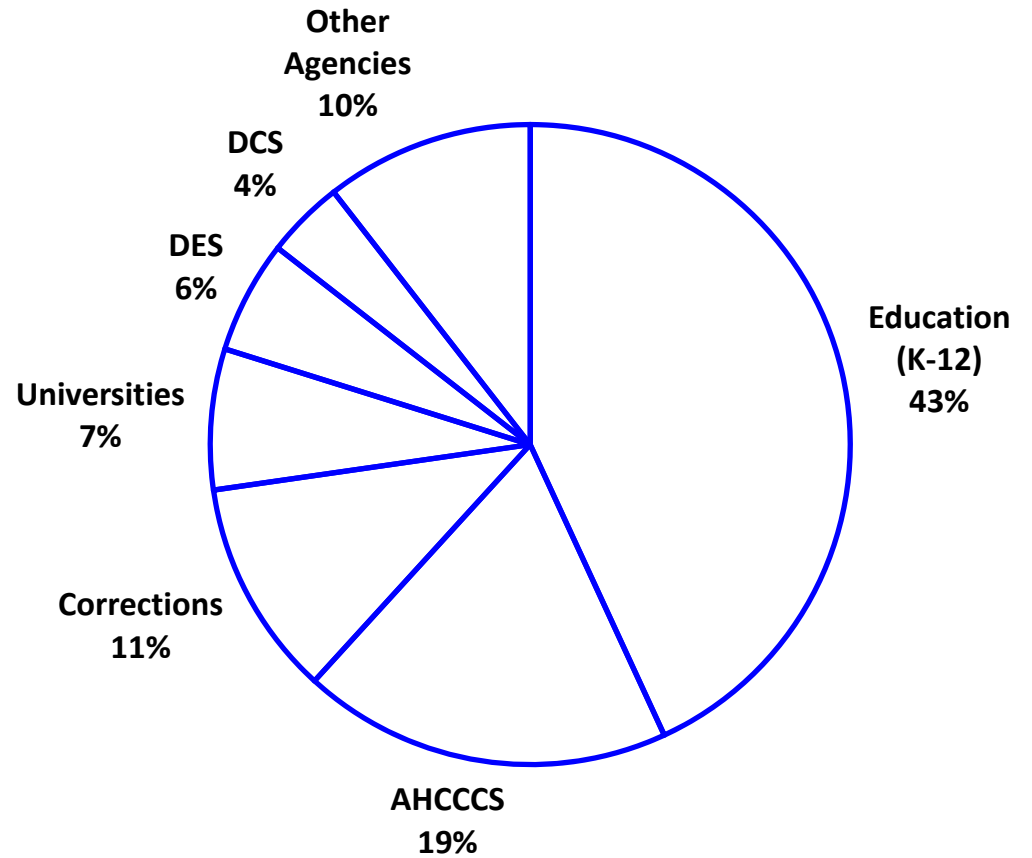
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- ❑ K-12 projected to grow by \$79 M
  - 1.37% inflation/1.4% student growth
  - \$(50) M in savings for previously enacted declining enrollment and small school weight provisions
  
- ❑ Medicaid '18 spending grows 2.7%
  - AHCCCS: 1.6% caseload, 3.0% capitation, better federal match
  - DES: 4.5% caseload, 2.5% capitation, better federal match
  
- ❑ DCS funding remains unchanged consistent with Legislative benchmarks to reduce the out-of-home population and the backlog
  
- ❑ ADC reflects cost for opening 1,000 previously authorized beds

# '18 General Fund Baseline

## - Where It Goes

<u>Budget Unit</u>	<u>\$ in Millions</u>
Education (K-12)	4,148.7
AHCCCS	1,795.0
Corrections	1,053.7
Universities	683.7
Economic Security	548.4
Child Safety	379.2
Other Agencies	1,012.9
<b>Total Spending</b>	<b>9,621.6</b>



# ADE 3-Year Spending Plan

	GF in \$ in M Above Prior Year		
	'18	'19	'20
Enrollment Growth (1.4% all years)	88	89	90
Higher Average Per Pupil Cost	21	21	21
Inflation (1.4% / 2.0% / 2.0%)	80	118	122
Higher Endowment	(16)	(15)	(10)
Property Taxes - New Construction	(51)	(54)	(56)
Statutory Expirations <sup>1/</sup>	(50)	0	0
College Prep Incentives (Previously Enacted)	5	0	0
Eliminate One-time Spending and Other <sup>2/</sup>	2	(24)	1
<b>Total Additional Spending</b>	<b>79</b>	<b>135</b>	<b>168</b>

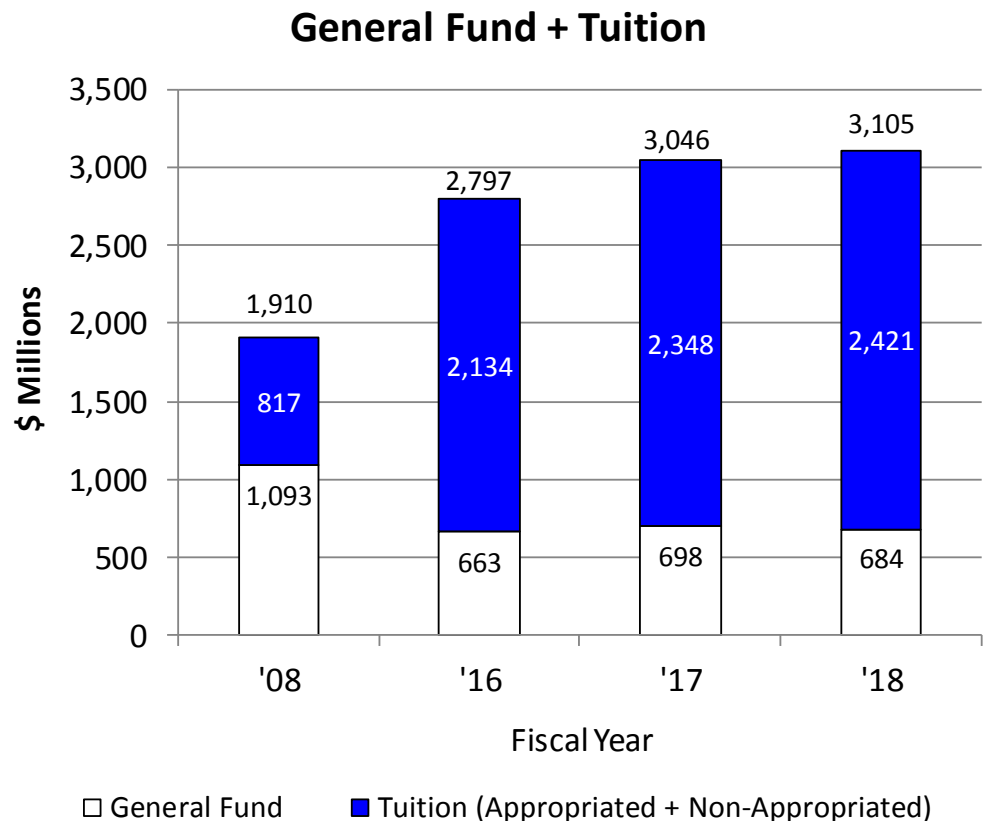
1/ '18 includes \$(31) M for statutory expirations of current-year funding backfill, \$(18) M for multi-site charter small school weights, and \$(1) M for district charters

2/ '19 includes \$(25) M from expiring SFB debt service

# University Baseline Declines by \$(15) M

## - Tuition Continues to Offset General Fund Loss

- ❑ Loss of \$(19) M one-time operating / capital monies
- ❑ Restoration of \$4 M in one-time debt savings
- ❑ '18 tuition not yet set; grew by \$200 M + in '17
- ❑ Recommend ABOR report \$400 M of full tuition/fees now excluded



# Medicaid Agencies Baseline Spending Changes

	GF \$ in M Above Prior Year		
	'18	'19	'20
AHCCCS	44	109	143
DES	18	27	30
<b>Total</b>	<b>62</b>	<b>136</b>	<b>173</b>
<b>% Growth</b>	<b>2.7%</b>	<b>5.8%</b>	<b>7.0%</b>

- ❑ AHCCCS base enrollment growth of 1.6%; DD growth of 4.5%
- ❑ AHCCCS Capitation growth of 3.0% in '18 and 3.5% in '19 and '20; DD growth of 2.5%
- ❑ Higher federal match rate generates some offsetting savings
- ❑ Baseline excludes Prop 206 provider rate increases
  - Lack of good data on minimum wage impact

# AHCCCS Caseload Grew by 48.4% in 3 years

<u>Population</u>	Enrollment (Thousands)		
	December <u>2013</u>	December <u>2016</u>	3-year <u>Change</u>
Traditional	880	1,093	213
Childless Adults	68	318	250
Adult Expansion	-	82	82
All Others	310	375	65
<b>TOTAL</b>	<b>1,258</b>	<b>1,868</b>	<b>610</b>

- ❑ General Fund pays for traditional population; hospital assessment funds childless adults and adult expansion
- ❑ Repeal of Affordable Care Act could result in a loss of federal funds.

# DCS Baseline Spending Remains Unchanged in '18

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- ❑ '18 Baseline spending is level with '17. But '17 is \$(23) M lower than '16 due to one-time funding
- ❑ Out-of-home population and backlog remain above benchmarks, but have decreased in recent months

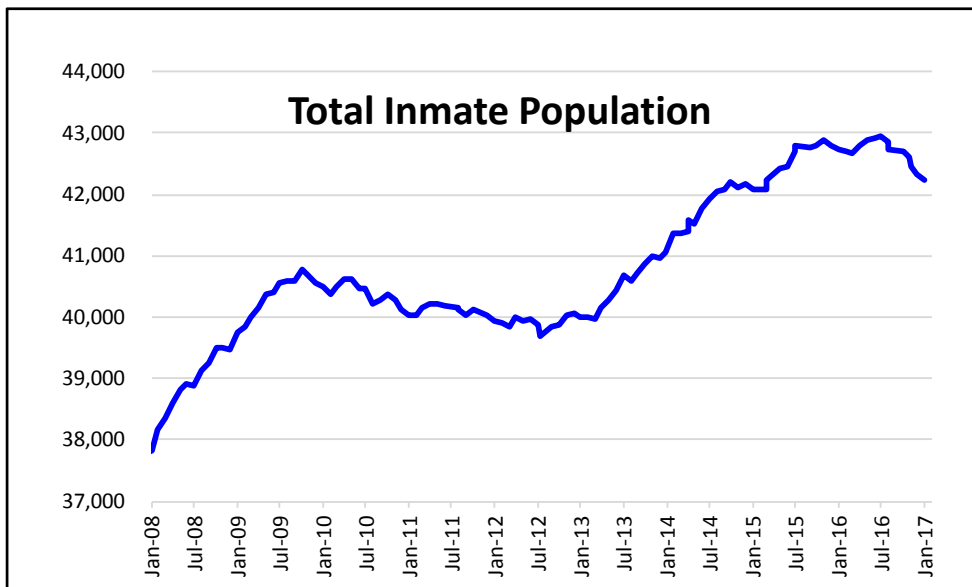
## Status of Benchmarks

	<u>Goal</u>	<u>Latest</u>
<b>Out-of-Home Children</b>	17,500	17,936
<b>Backlog</b>	1,000	2,854
<b>Filled FTE Positions</b>	1,406	1,340
<b>Open Reports</b>	13,000	9,611



# Department of Corrections Baseline Grows by \$7.1 M

- ❑ Baseline annualizes 1,000 new private beds opened in '17
- ❑ Population has declined, currently at March 2015 level
- ❑ ADC total male bed surplus expected to be 1,625 in 6/18 (including 5,700 temporary beds)



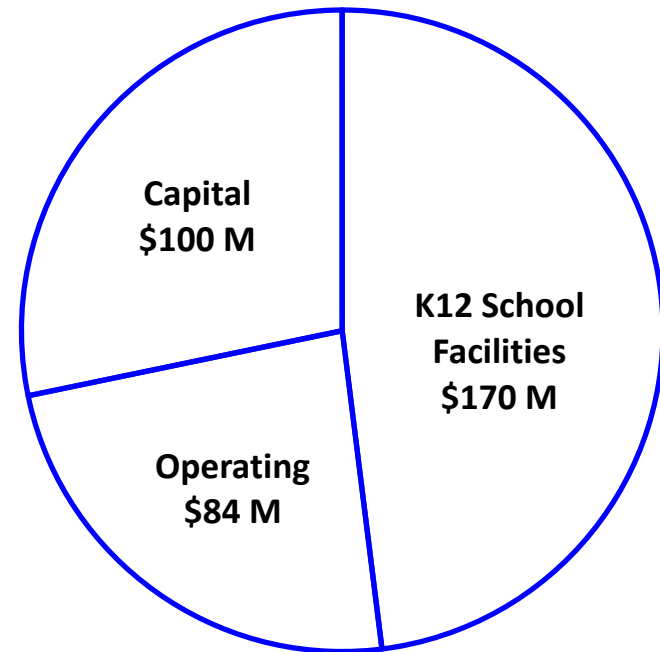
<b>June 2018 Total Male Bed (Shortfall)/Surplus</b>	
<u>Classification Level</u>	<u>June '18</u>
Minimum	421
Medium	476
Close	385
Maximum	343
<b>Total</b>	<b>1,625</b>

# General Fund Debt Service Will Cost \$354 M In '18

- Equivalent to 7th Largest Budget Unit

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- State has \$7.3 B in outstanding debt and lease-purchases
- General Fund share is \$2.1 B



GF Debt Service = \$ 354 M

# State Retirement GF Cost Growing by \$12 M

## - Baseline Excludes Higher Cost, Primarily ADC

- ❑ Overall, employer contributions cost \$194 M from the General Fund and \$512 M from total funds
- ❑ '18 rates do not include impact of Hall ruling — State not allowed to change employer contribution or COLA for certain existing retirees

<b>Employer Rates</b>	<b>Funded Status</b>	<b>Employer '17 Rate</b>	<b>Employer '18 Rate</b>	<b>'18 GF Cost Increase</b>
ASRS	77.0%	11.48%	11.50%	\$0.1 M
PSPRS (Aggregated)	46%	42.61%	52.09%	\$2.8 M
CORP (Aggregated)	57.3%	18.71%	20.98%	\$9.4 M
EORP	37.6%	23.50%	23.50%	\$0.0 M

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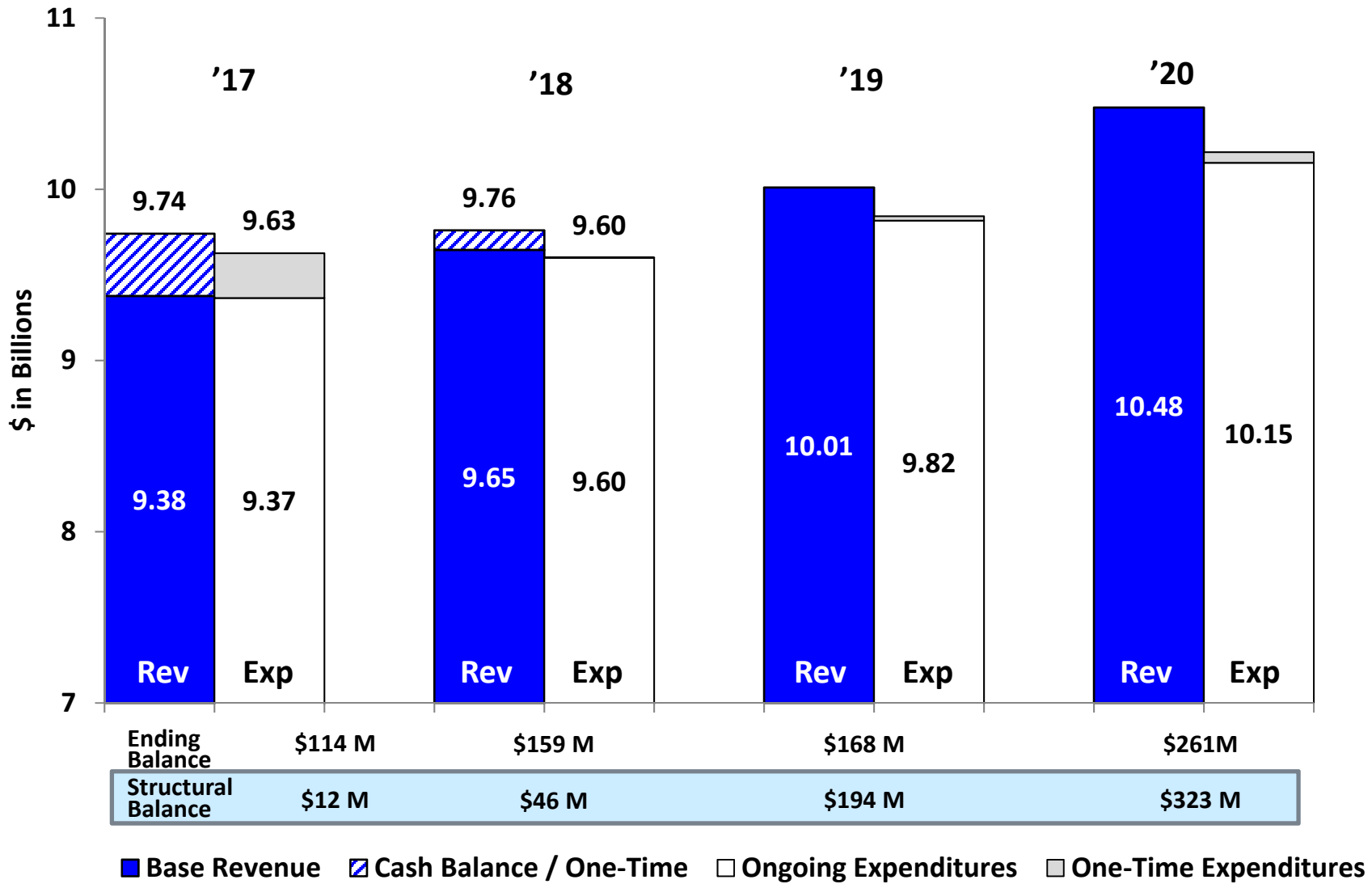
# **Cash and Structural Balance Forecast**

# '18 Structural Vs. Cash Balance

FY 2018 Baseline Projection	
(\$ in M)	
<u>Baseline</u>	
Balance Forward	\$ 114
Ongoing Revenues	9,646
Ongoing Spending	(9,600)
One-Time Spending	(1)
<b>Cash Balance</b>	<b>\$ 159</b>

\$46 M Structural Balance

# Baseline Balance Improves Over Time, But...

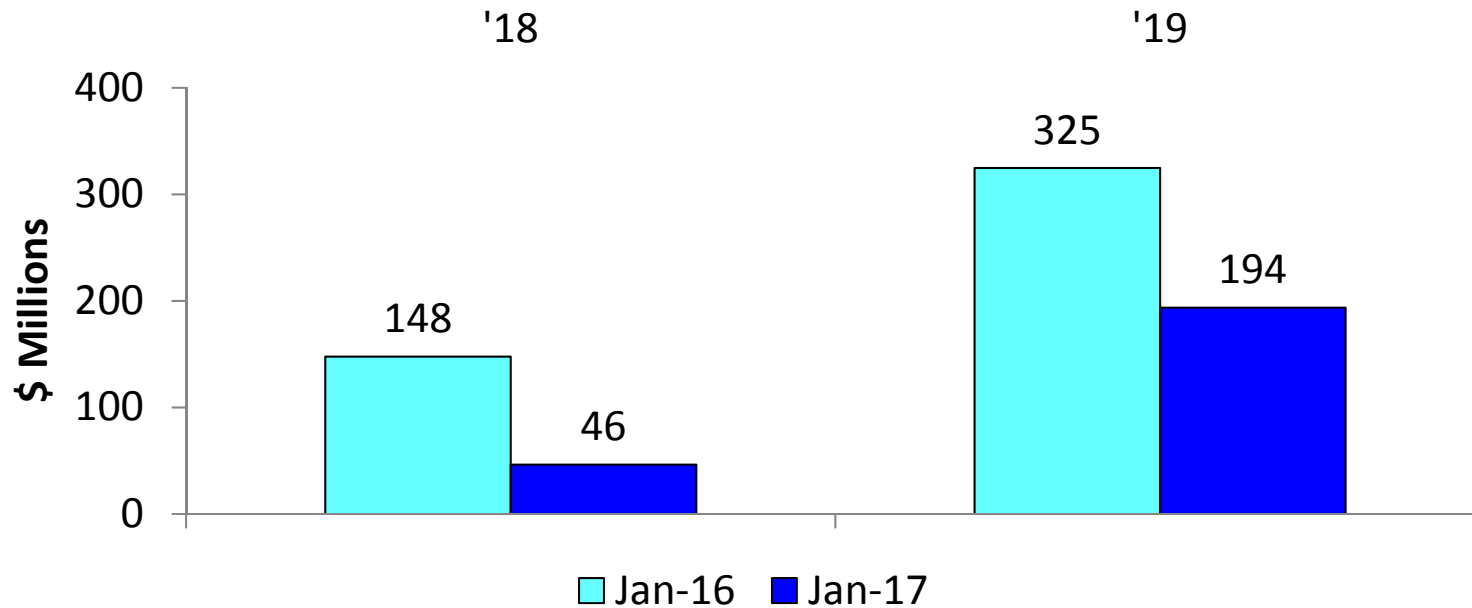


Projected ending balances assumed to be allocated as part of the budget process

# Structural Balance Estimates Are Volatile

## - Risks of Developing Budget Around '19 or '20 Estimates

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- ❑ 1% variance in revenue estimates yields \$625 M over 3 years
- ❑ Assumes no discretionary changes in next 3 years
- ❑ Lower revenues and higher spending reduced projected '18 balance from \$148 M to \$46 M in 12 months.

# Appendix A: January 2017 4-Sector Forecast

	<u>2017</u>	<u>2018</u>	<u>2019</u>	<u>2020</u>
<b>Sales Tax</b>				
JLBC Forecast	4.0%	4.1%	4.1%	4.0%
UA – Low	3.2%	2.0%	3.7%	5.6%
UA – Base	4.1%	5.0%	5.6%	5.3%
FAC	4.1%	4.0%	3.9%	4.0%
Average:	<b>3.9%</b>	<b>3.8%</b>	<b>4.3%</b>	<b>4.7%</b>
<b>Individual Income Tax</b>				
JLBC Forecast	4.0%	5.8%	4.9%	4.9%
UA – Low	3.9%	3.7%	3.9%	5.9%
UA – Base	4.8%	6.1%	5.6%	5.5%
FAC	5.1%	4.9%	4.7%	4.8%
Average:	<b>4.5%</b>	<b>5.1%</b>	<b>4.8%</b>	<b>5.3%</b>
<b>Corporate Income Tax</b>				
JLBC Forecast	-7.0%	4.7%	3.1%	-0.1%
UA – Low	-5.8%	-12.1%	-17.7%	13.5%
UA – Base	-2.0%	-3.3%	-6.3%	-3.4%
FAC	-14.1%	1.9%	3.8%	2.0%
Average:	<b>-7.2%</b>	<b>-2.4%</b>	<b>-3.9%</b>	<b>2.0%</b>
<b>Insurance Premium Tax</b>				
JLBC Forecast	6.4%	4.5%	5.1%	4.7%
UA – Low	7.4%	3.2%	2.6%	2.0%
UA – Base	7.4%	3.2%	2.4%	2.4%
FAC	6.4%	5.5%	4.9%	5.2%
Average:	<b>6.9%</b>	<b>4.1%</b>	<b>3.8%</b>	<b>3.6%</b>

JLBC Weighted Average	<b>3.5%</b>	<b>4.9%</b>	<b>4.5%</b>	<b>4.3%</b>
UA Low Weighted Average	<b>3.2%</b>	<b>2.2%</b>	<b>3.1%</b>	<b>5.7%</b>
UA Base Weighted Average	<b>4.2%</b>	<b>5.0%</b>	<b>5.0%</b>	<b>5.0%</b>
FAC Consensus Weighted Average	<b>3.6%</b>	<b>4.4%</b>	<b>4.3%</b>	<b>4.4%</b>
“Big-4” Weighted Average	<b>3.6%</b>	<b>4.0%</b>	<b>4.1%</b>	<b>4.7%</b>
Consensus Weighted Average*	<b>3.5%</b>	<b>3.9%</b>	<b>4.2%</b>	<b>4.8%</b>
Adjusted Consensus Weighted Average**	<b>2.2%</b>	<b>2.9%</b>	<b>3.5%</b>	<b>4.5%</b>

\* Represents ongoing revenue adjusted for small revenue categories.

\*\* Represents ongoing revenue adjusted for tax law changes; excludes urban revenue sharing.





**STAFF OF THE  
JOINT LEGISLATIVE BUDGET COMMITTEE**

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..... Stefan Shepherd  
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Principal Fiscal Analyst..... Eric Billings  
Senior Fiscal Analysts..... Steve Grunig  
..... Chris Gustafson  
..... Micaela Larkin  
..... Rebecca Perrera  
..... Jon Stall  
Fiscal Analysts..... Matt Beienburg  
..... Morgan Dorcheus  
..... Henry Furtick  
..... Jeremy Gunderson  
..... Josh Hope  
..... Patrick Moran  
Assistant Fiscal Analyst..... Ben Murphy  
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