

FY 2008
JLBC Baseline

January 2007



The FY 2008 JLBC Baseline Estimate

- As a starting point for discussions on the FY 2008 budget, the JLBC has developed:
 - An estimate of revenues, reflecting a consensus economic forecast.
 - An estimate of spending required by funding formulas and other obligations, less one-time FY 2007 costs.
 - An estimate of available resources after adjusting for Baseline revenues and spending.
- The Baseline is not a recommended budget, as discretionary issues are not generally addressed.

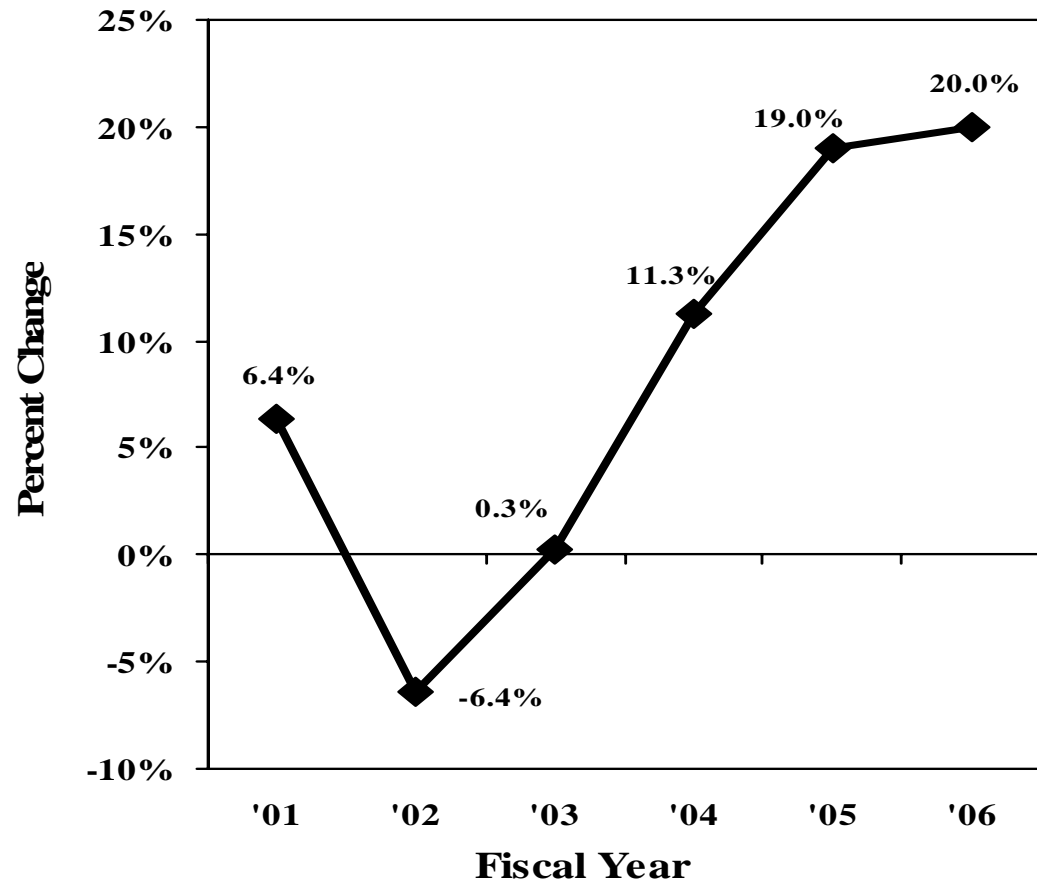
The FY '08 Baseline Has Substantially Less Available for Discretionary Purposes than the FY '07 Budget

- The consensus revenue forecast reflects below average growth.
- Previously enacted legislation already committed \$380 M in new tax reductions and new spending for FY '08.
- Urban Revenue Sharing will grow 24% – based on 2-year old data – while FY '08 income taxes grow less than 1%.
- After accounting for normal formula growth, General Fund cash balance is \$45 M.
- On-going spending, however, outpaces on-going revenues by \$408 M.

Revenue Overview

General Fund Revenues Have Grown Rapidly in the Last 2 Years

- **20% FY '06 Growth**
 - Sales Tax = 16.7%
 - Individual Income Tax = 24.1%
 - Corporate Income Tax = 24.6%
- **2-Year growth for '05 and '06 of almost 40% greatest in at least 35 years.**



Base revenues prior to tax law changes.

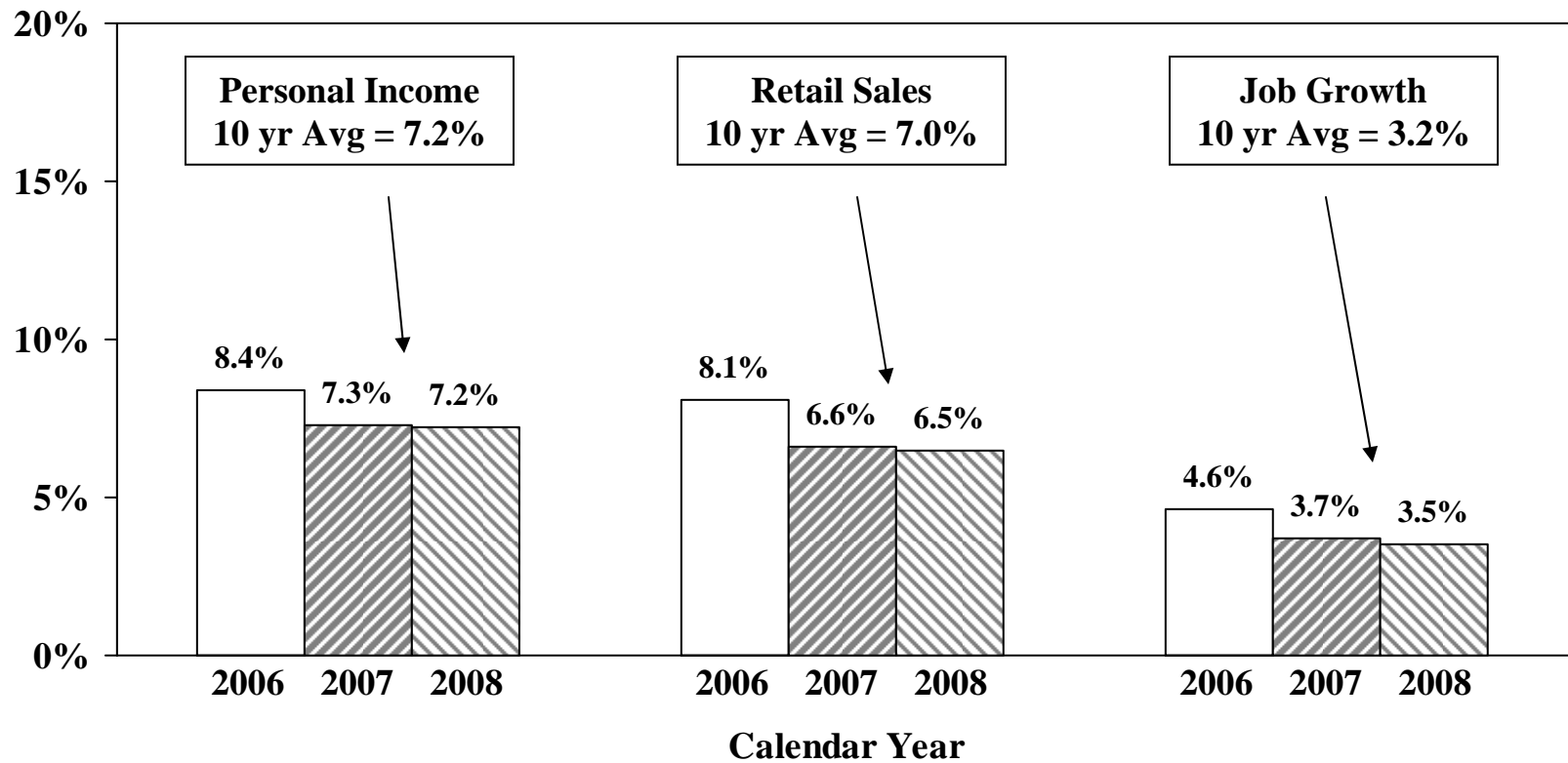
Growth in 1st Six Months of FY 2007 Is Above Forecast, But Last 2 Months Have Been Disappointing

- Contracting portion of sales tax is up 20%; unlikely to continue.
- November-December growth rate only 3%.
- Remainder of FY '07 needs to be closely monitored.

<u>Category</u>	<u>Year-to-Date % Growth</u>
Sales Tax	9.4%
Individual Income Tax	7.1%
Corporate Income Tax	23.1%
Total	9.3%

Where Do We Go From Here?

- Arizona Blue Chip '07 and '08 Forecast Remains Near Historical Averages



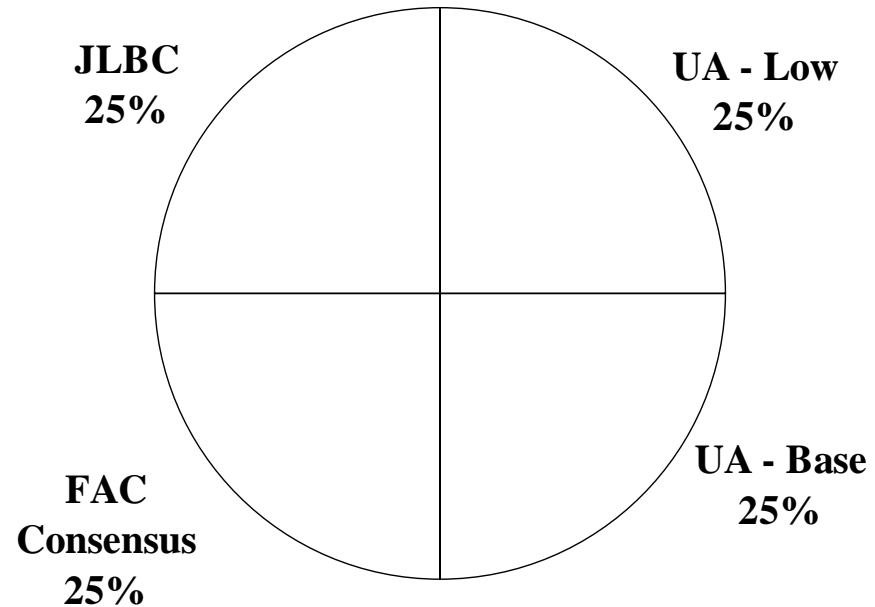
Source: November 2006 Arizona Blue Chip

“Big 3” Tax Forecast Uses Four-Sector Consensus

- Translates Broad Economic Projections into General Fund Revenues

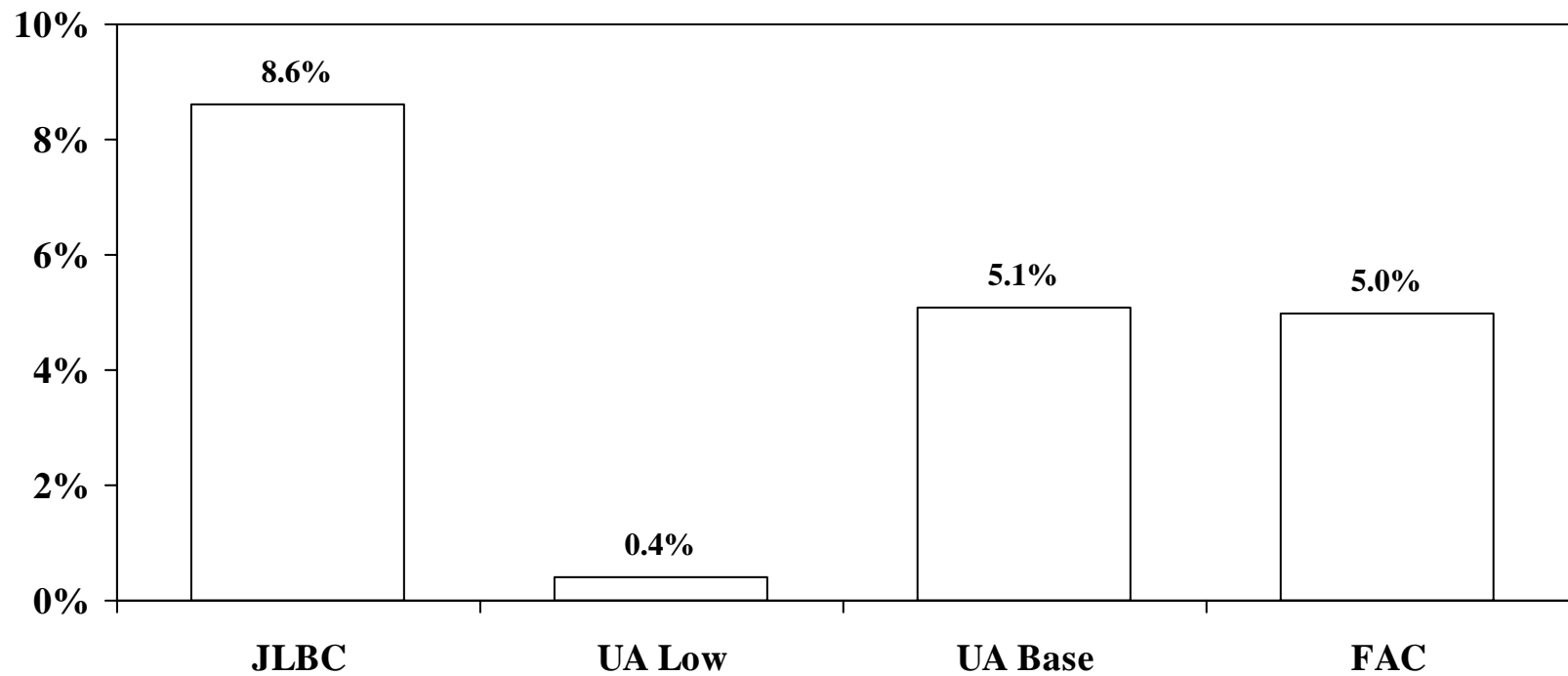
Big 3 forecast equally weights:

- **FAC average**
- **UofA model - base**
- **UofA model - low**
- **JLBC Staff forecast**
- **Remaining revenues (5% of total) are staff forecast**



The Four Inputs to JLBC Consensus Revenue Estimate Vary Significantly

- UA Low Model Represents A Recession Scenario



“Big 3” FY 2008 Revenue Growth Forecast (Weighted Average)
Prior to Tax Law Changes

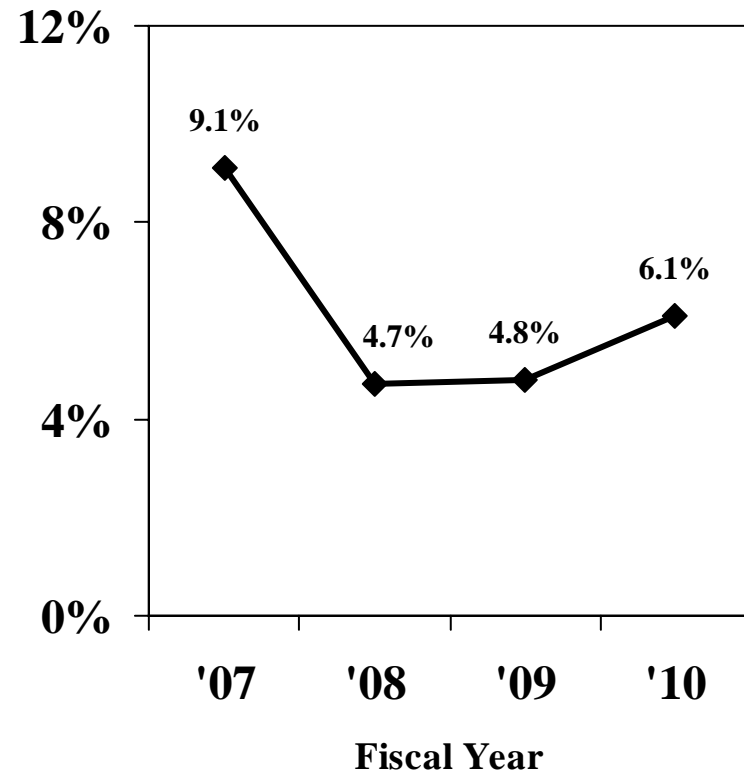
Evaluating the Odds of Flat Revenue Growth - How Does that Compare to the Odds of a Recession?

- National Blue Chip places the odds of a recession at 25% in the next 12 months
 - Based on responses from 55 panelists
 - 10 most optimistic place odds at average of 15%
 - 10 most pessimistic place odds at average of 36%
- Arizona Blue Chip was asked when the next recession would occur in Arizona
 - 13% said prior to 2008
 - 20% said 2008
 - 67% said 2009 or beyond

The Four-Sector Consensus Results in 4.7% Revenue Growth in the FY 2008 JLBC Baseline

- Growth Prior to Tax Law Changes
- Would Be Lowest Growth Since FY 2003

- '07 Baseline based on JLBC Staff growth rate of 9.1% - up from 4-sector projection of 8.2%.
- Based on last 2 months, however, '07 may need to be adjusted downward.
- '08 Baseline based on 4-sector consensus.



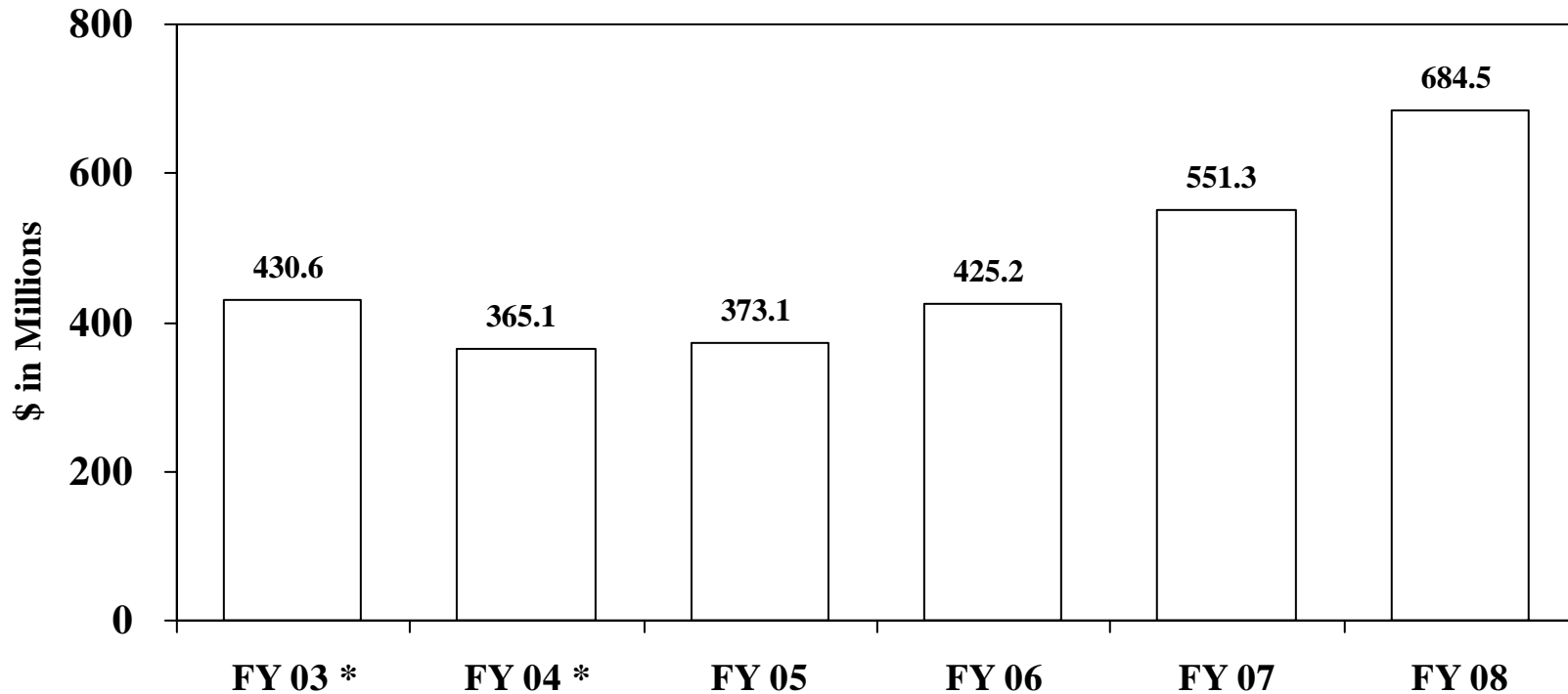
\$(216) Million in Prior Tax Law Changes Take Effect in FY 2008

- Lowers Net Revenue Growth from 4.7% to 2.6%

- Several tax law changes will become effective in FY 2008:
 - 2nd year of individual income tax rate reduction - \$(178) M.
 - Corporate sales factor - \$(32) M.
- Estimates are static – dynamic impacts usually generated over several years.
- '94 legislation on corporate consolidated credit will also result in one-time \$(55) M loss.

FY 2008 Urban Revenue Sharing to Cities Will Grow by \$133 M

- **24% Growth Based on Income Tax Collections in FY 2006 – While FY '08 Income Tax Collections Are Projected to Increase Less Than 1%**
- **Distribution Further Reduces Revenue Growth from 2.6% to 1.4%**



* Distributions to cities for FY 2003 and FY 2004 were based on 14.8% of income tax collections 2-years prior rather than 15%.

Spending Overview

Arizona Has A Unique Annual-Biennial Budget Process

- Recommend Generally Conforming to Statutory List

- Largest agencies go through budget process annually – agencies identified in statute.
- All other agencies receive 2 years of funding in 1st Regular Session.
- Cycle frees up time in 2nd Regular Session for more in-depth consideration of annual budgets or other policy issues.

JLBC Baseline Annual Budgets		
	<u>Statutory</u>	<u>Non-Statutory</u>
ADOA	Judiciary	Mine Inspector
AHCCCS	DJC	Navigable Stream
Comm Colleges	SFB	DPS
ADC	ADOT	Treasurer
DES	Universities	
DHS		

JLBC Baseline Spending Guidelines

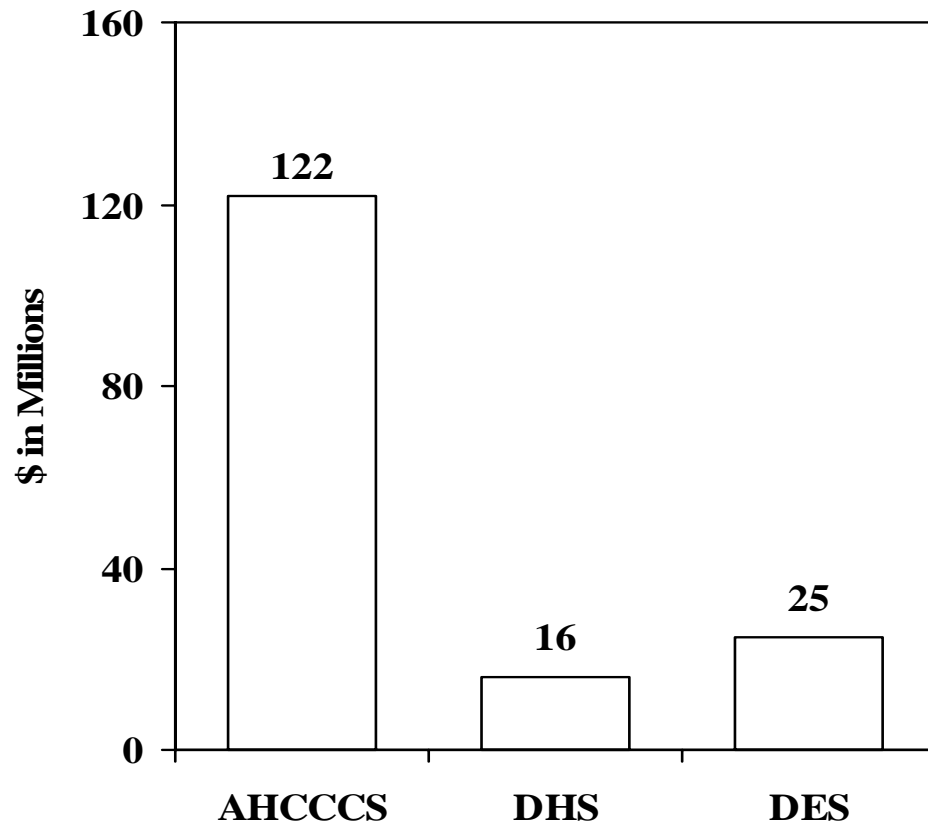
- General Fund Baseline spending estimates are typically based on funding formula growth.
- Does not continue \$68 M in General Fund spending designated as one-time in the FY '07 budget, and \$56 M in one-time transfers.
- Vetoed Border Enforcement funding is not in Baseline.
- Baseline does not generally address new discretionary General Fund issues for FY '08, but does include recommendations for new non-General Fund Spending.

Title 19 and Health & Welfare Programs

FY 2008 Statutory Spending is \$163 M Above FY 2007

FY 2008 Title 19 Growth Rates

	<u>Population</u> <u>June/June</u>	<u>Cap Rate</u>
AHCCCS	3.0%	6.0%
DHS	3.0%	8.0%
DES	5.7%	3.5%



Resolution of Federal/Tobacco “Backfill” Issues to be Addressed During Session

- Possible \$60 M Loss of Federal/Tobacco Funds
- Due to Uncertainty Over Executive Proposal and Potential Solutions, JLBC Baseline Does not Fund

	<u>(\$ in M)</u>
• Prop. 203’s Tobacco Tax increase will likely reduce smoking and AHCCCS’ current tobacco revenues – estimate subject to change.	15
• Federal Deficit Reduction Act reduces foster care and child support funding (of \$36 M, \$19 M is ’07 Shortfall).	36
• Federal government reducing support for large facility mental health care.	9

Voter Approval of Early Childhood Development Initiative Will Significantly Increase Funding

- Proposition 203 increased the cigarette tax by 80¢ a pack and was projected to generate \$188 M in FY '08.
- Estimate being reviewed in light of Attorney General opinion.
- Will fund pre-kindergarteners for child care, preschool, preventative health, and family support services.
- New agency can keep up to 10% (\$19) M for administration.
- Spending not subject to appropriation.

K12 Operating

FY 2008 Growth is \$293 M

\$ M

\$ 183	– 3.3% enrollment growth – based on average of JLBC Staff/UA model
34	– Fully funds JTED formula
84	– 2% inflation
80	– Complete enacted phase-in of K-weight increase
(182)	– 13.2% net assessed value (NAV) growth
90	– TNT – 5.6% existing property growth
12	– Business property tax phase-down
<u>(8)</u>	– Remove FY '07 one-time funding
\$ 293	– Total

Continues '07 level of English Learner appropriations

K12 Capital – the School Facilities Board

FY 2008 Growth is \$136 M

- JLBC estimates the new construction program at \$370 M GF for FY '08, a \$120 M increase, due to:
 - Fund balances are no longer available to fund new construction.
 - \$200 M more in '06 new construction approvals above '05
 - significant spend out starts in '08.
 - Precise impact of housing slowdown difficult to predict; SFB's estimate is \$30 M higher.
- Baseline funds building renewal at \$106 M.
 - Requires a \$19.3 M increase above '07 due to inflation, new space, and building age increases.

Higher Education

FY 2008 Growth is \$51 M

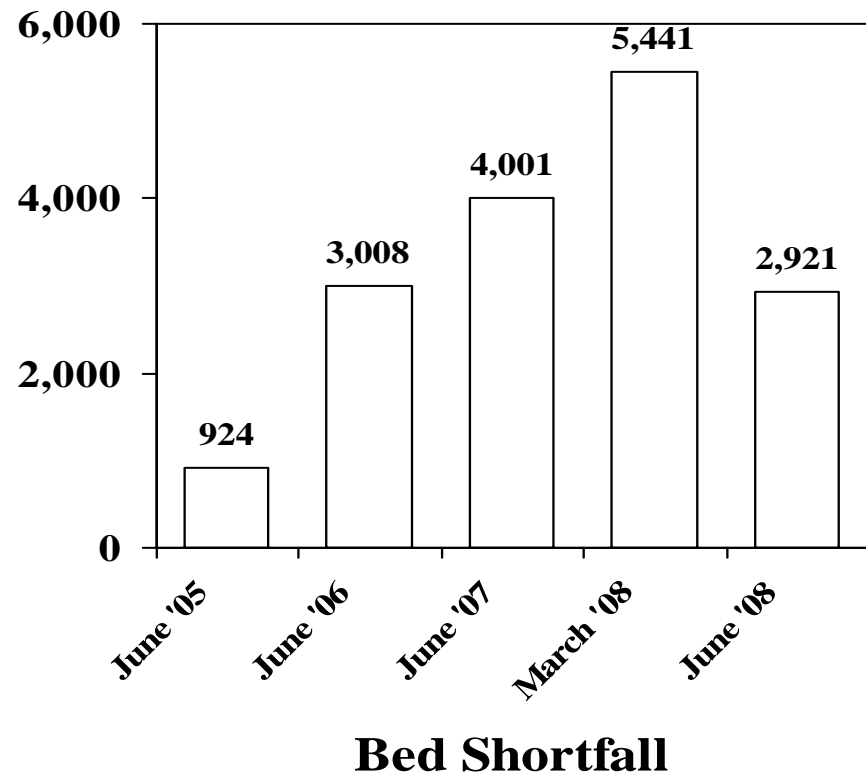
- University enrollment formula growth of 2.5% would cost \$20.0 M.
- Authorized in 2003, Research Building lease infrastructure payments of \$34.6 M begin in FY '08 (25-year term).
- Baseline does not address additional UA – Phoenix Medical School funding.
- Community College funding is flat.
 - + \$200 K for operating and capital – Enrollment decrease of (1.3)%, but declining districts held harmless.
 - + \$3.5 M for 17% equalization growth.
 - \$4.0 M for one-time funding.

Corrections Spending Would Grow by \$20 M

- 3,000 Beds Will Open in FY 2008 to Address Bed Shortfall

- State Has Experienced Rapid Inmate Growth in Last Year

- Inmate growth of 2,344 in last 12 months, compared to 965 in prior year.
- Bed shortfall will reach 5,400 before 3,000 new beds authorized last session will open.
- '08 increases include:
 - \$11 M to ADOA to open 3,000 beds.
 - Remainder funds annualization of '07 beds and inflation.

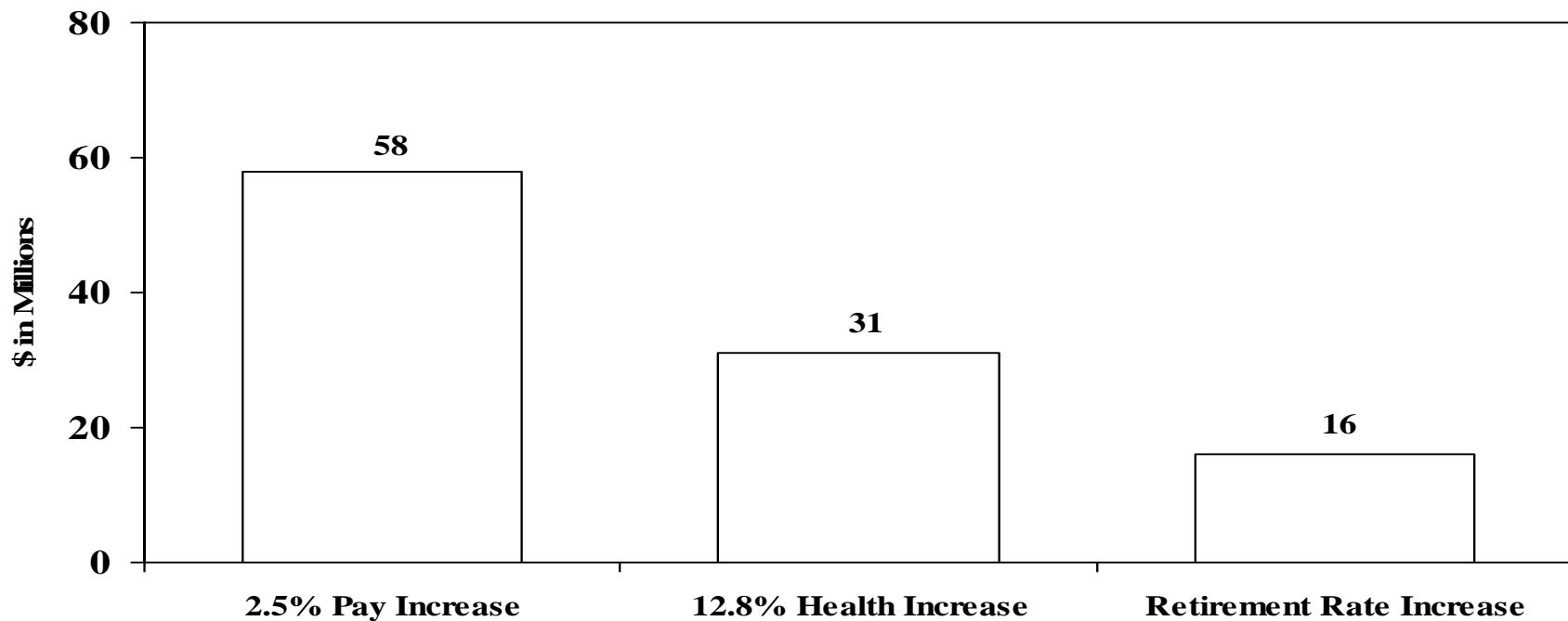


DPS Major Issues

- Baseline continues \$17 M GITEM Program expansion included in FY '07 budget:
 - \$7 M for DPS direct expenses – expect to hire 37 FTEs and spend \$5.9 M in '07.
 - \$10 M for local governments – expect to hire 10 FTEs and spend \$2.3 M in '07.
 - '07 monies non-lapsing through June '08.
- Baseline continues FY '07 policy of shifting \$98 M of HURF/Highway costs for Highway Patrol to the General Fund, thereby freeing up road construction dollars.
- While the shift was labeled as one-time in FY '07, now considered as permanent since it complies with statutory caps on use of Highway Funds for DPS.

State Employee Issues in JLBC FY 2008 Baseline

\$105 M in FY 2008 Spending Above FY 2007



Baseline Funds \$41 Million in Capital Projects *

	<u>\$ in M</u>
• University 26% building renewal; ADOA funded at same rate through rent.	18.8
• Department of Corrections locks (2 nd year).	8.5
• Renovate old Health Lab.	4.4
• Archives building (already approved).	8.0
• DPS microwave tower (already approved).	1.5

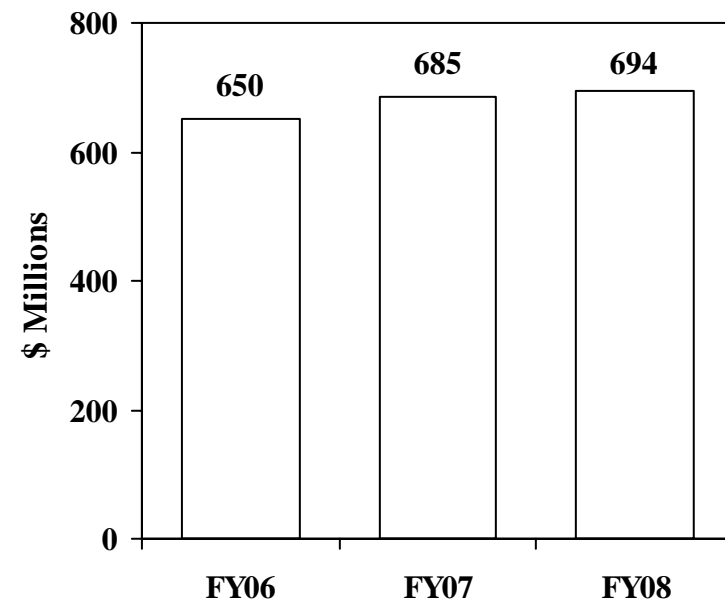
* Pending further legislative discussion, does not include another General Fund contribution to highway construction.

Budget Stabilization Fund

- Fully Funded at Cap of 7% of GF Revenues

- Permanent statute caps balance at 7% of GF
- '07 funding = \$10 M appropriation and interest earnings.
- '08 funding from interest earnings only.

Total Fund Balance



After Accounting for Consensus Revenue and Formula Spending, JLBC Baseline has a \$45 Million Cash Balance

REVENUE

<p style="text-align: center;">New Revenue - \$822 M</p> <p style="text-align: center;"><i>New Revenues of \$357 M + Carry Forward of \$550 M + Net One-Time Changes of \$131 M Less Enacted '08 Tax Changes of \$(216) M</i></p>

SPENDING

Title 19 Health and Welfare Formula \$163 M
K-12 Formula \$293 M
SFB \$136 M
Higher Ed \$51 M
Corrections \$20 M
Employee Salary, Health, Retirement \$105 M
Capital \$41 M
Other - \$(32)M

Net New Available \$822 M
Total Available \$10.47 B

← **\$45 M** →
Balance

Net New Spending \$777 M
Total Spending \$10.42 B

FY 2008 Spending Growth Varies Significantly Depending on Whether On-Going or Total Spending is Measured

- FY '07 one-time spending included Highways (\$245 M), Rollover Repayment (\$191 M), and Litigation Settlement (\$110 M)

	<u>FY '07</u>	<u>FY '08</u>	<u>% Growth</u>
• On-Going Spending	\$ 9,576	\$ 10,381	8.4%
• One-Time Spending	<u>761</u>	<u>41</u>	
Total	\$ 10,337	\$ 10,422	0.8%

Beyond Its One-Time Cash Balance, the FY 2008 Budget Can Be Measured in Terms of On-Going Commitments

- On-going spending can exceed on-going revenues in any one year as long as one-time monies are available to balance the budget.
- Multiple years of on-going deficits (permanent spending exceeding permanent revenues) create challenges as the state attempts to generate new sources of revenue.
- Long term numbers are very sensitive to small percentage changes:
 - A 1% revision in revenues or spending over 3 years changes the long-term impact by \$600 M.

While JLBC Baseline Cash Balance is \$45 M, On-Going Spending is Short of Revenues by \$408 M

•Total FY 2008 Revenue Includes \$550 M in
One-Time FY 2007 Carry Forward

	Total \$ <u>(\$ in M)</u>	On-Going \$ <u>(\$ in M)</u>
• Total Revenues	\$ 10,467	\$ 9,973
• Total Expenditures	<u>10,422</u>	<u>10,381</u>
Available Resources	\$ 45	\$ (408)

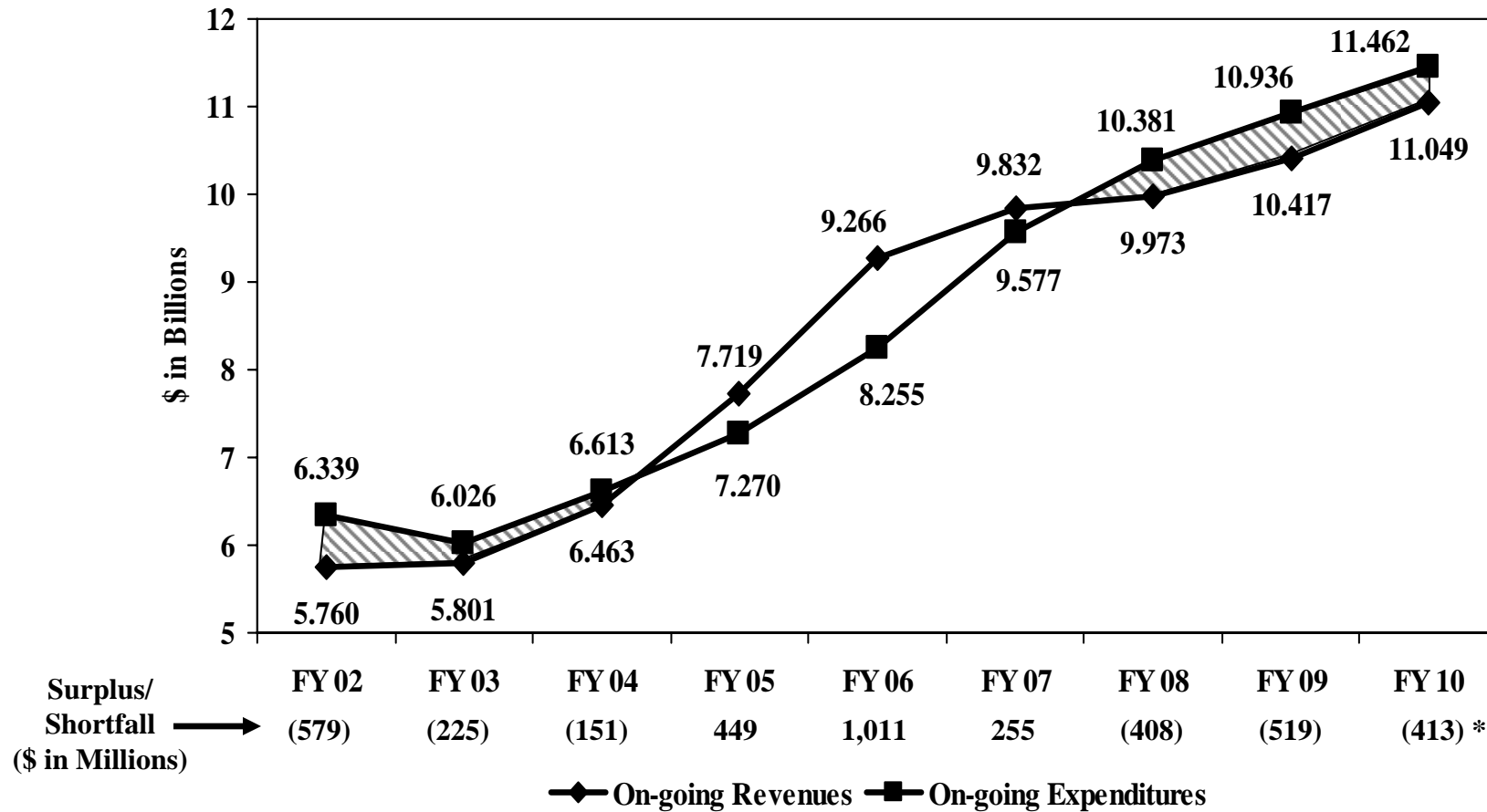
Long Term Budget Scenario Similar to FY 2008

- Projected Cash Balance Would Also Be Negative

- Revenue growth is based on consensus estimates:
 - 4.8% in '09 and 6.1% in '10.
- Spending growth is based on JLBC FY '08 Baseline plus formula growth in FY '09 and FY '10.
- Estimates assume continuation of current temporary provisions.
- In FY '09 and FY '10, state would experience cash and on-going shortfalls of \$400 M to \$500 M.
- If temporary provisions are not continued, on-going shortfall is closer to \$270 M in FY '10.

On-Going Revenues Compared to On-Going Spending

- Economic Recovery Turned \$579 M Deficit into \$1.0 B Surplus, But Economic Slowdown Recreates the Deficit



* \$(270) M if current statutory provisions are not extended.



Potential Process Improvements

- Improve state's financial reports: one report lists the General Fund as \$9 B in FY '05, while another says \$17 B.
- Make a more user-friendly 5 Year Highway Plan.
- Expand actuarial audits: Health Care Group.
- Conduct two new Strategic Program Area Reviews:
 - Substance abuse
 - Debt and third party financing
 - JLBC Staff and OSPB will review these cross-agency topics and present findings for consideration in the 2008 session
- Improve compliance with statutory performance measures.

26 Agencies Failed to Provide Statutory Performance Measures

- Of 42 Unreported Measures, 37 Involve Customer or Client Satisfaction

Acupuncture Board of Examiners (1)
Arizona Department of Administration (11)
Arizona Department of Agriculture (1)
Arizona Health Care Cost Containment System (1)
Arizona Community Colleges (2)
State Board of Dental Examiners (1)
Department of Economic Security (2)
Department of Emergency and Military Affairs (1)
State Board of Equalization (3)
Board of Executive Clemency (1)
State Board of Funeral Directors and Embalmers (1)
Arizona Game and Fish Department (2)
Government Information Technology Agency (1)
Department of Health Services (1)
Prescott Historical Society (1)

Board of Homeopathic
Medical Examiners (1)
Arizona Commission of Indian Affairs (1)
Board of Medical Student Loans (1)
State Mine Inspector (1)
Board of Examiners of Nursing Care
Institution Administrators & Assisted
Living Facility Managers (1)
State Board of Optometry (1)
Board of Physical Therapy Examiners (1)
State Board of Podiatry Examiners (1)
Structural Pest Control Commission (1)
State Board of Tax Appeals (2)
State Board of Technical Registration (1)

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