
Finance Advisory Committee

Revenue and Budget Update

January 23, 2014

JLBC

3-Year Budget Outlook

- ❑ The Baseline compares the 4-sector consensus revenue forecast with cost of current funding formulas through '17
- ❑ Under the Baseline scenario, the cash balance is \$327 M in '15, near \$0 in '16, and a \$(593) M shortfall in '17
- ❑ After adjusting the Baseline for the \$238 million HURF proposal, there are projected shortfalls of \$(256) M in '16 and \$(593) M in '17
- ❑ The cash balance estimates exclude the \$460 M available in the Budget Stabilization Fund

The Caveats

- ❑ The revenue forecast is based on moderate revenue growth – but assumes that a portion of ‘13 capital gain windfall was one-time
- ❑ Over 3 years, small percent changes in growth assumptions can have a substantial impact
 - Eliminating the 4-sector slow growth scenario, for example, could increase available revenues by \$468 M through ‘17
- ❑ Pending “budget” lawsuits could be significant. Retroactive K-12 inflation payments have a maximum exposure of \$1.26 B
- ❑ Baseline includes \$210 M to buy back debt in ‘17 under 2010 debt financing terms – but Executive could revise these terms

Legislative Considerations

- ❑ While there is a cash balance at least through '15, ongoing spending exceeds ongoing revenue in each year (a structural shortfall)
 - Through '17, the annual structural shortfall ranges from \$(328) M to \$(383) M
 - The \$900 M '13 carryforward keeps the cash budget balanced in the short term
- ❑ The state still annually suspends over \$300 M of funding formulas and rolls over \$1.2 B in spending (both primarily K-12)
- ❑ Among states, Arizona is tied for the 3rd lowest credit rating – but outlook has turned positive

Rating Agency Perspectives on Arizona – Revised from Stable to Positive Outlook

– Aa3 Moodys/AA- Standard and Poors

☐ Strengths

- Improving economy in terms of job and housing growth
- \$1.3 B budget balance and Rainy Day Fund at the end of '13
- Below average debt and pension liabilities

☐ Weaknesses

- Structural shortfall with expiration of 1 cent sales tax
- Constitutional restrictions on flexibility – Propositions 105 and 108
- Lack of financial best practices – statutory consensus forecasting and Executive mid-year budget reduction authority

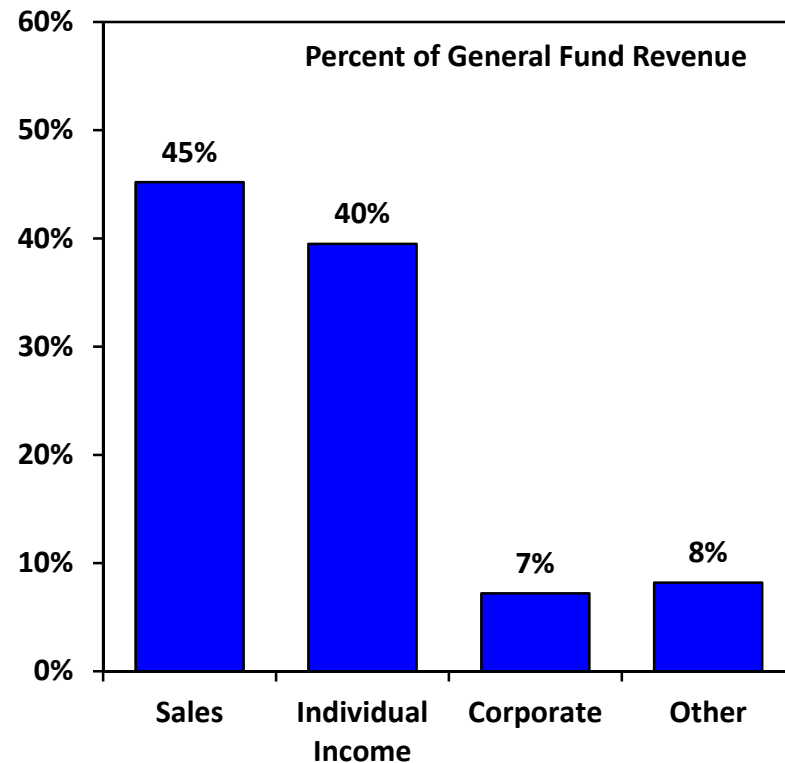
Revenue Overview

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FY 2015 General Fund Revenue

- 92% Generated by 3 Taxes

<u>Source</u>	<u>(Millions)</u>
Sales and Use Tax	\$ 4,207.6
Individual Income Tax	3,675.8
Corporate Income Tax	667.0
Other	<u>766.7</u>
TOTAL REVENUE	\$ 9,317.1^{1/}



^{1/} Excludes beginning balance, urban revenue sharing, and one-time revenue adjustments, but includes all on-going legislative revenue changes.

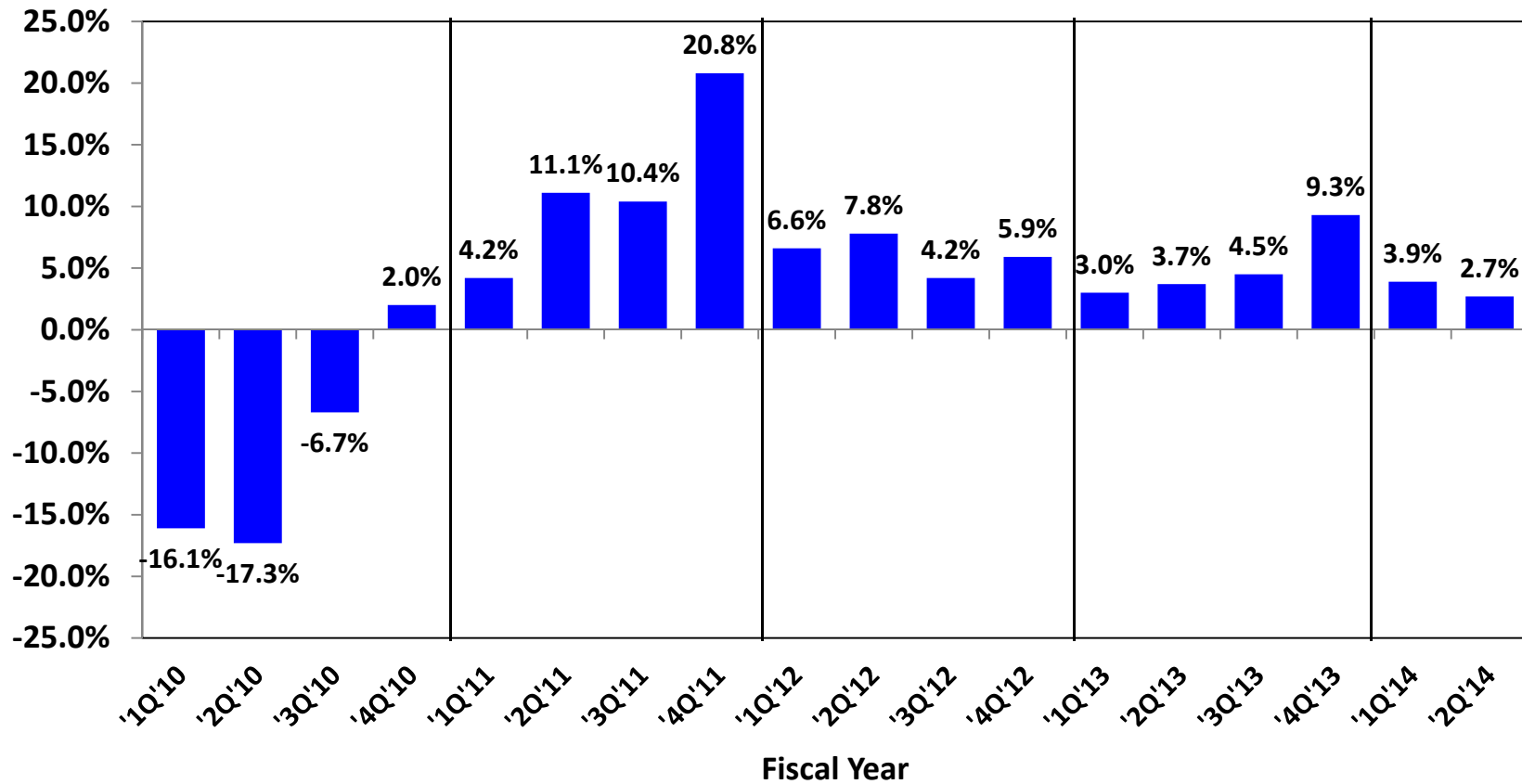
1st Half FY '14 Growth Rate 3.2%

- After Technical Adjustments, More Likely to be 4.0%
- \$10 M Above Original Budget Forecast

	Preliminary % Change over Prior Year
Sales Tax	6.7%
Individual Income Tax	3.4%
Corporate Income Tax	(14.8)%

- Strong sales tax growth led by retail and contracting
- Income tax withholding has increased by only 1.7%
- Increased use of tax credits may account for corporate decline

After Strong 4th Quarter of FY '13, Growth Has Slowed



Key Economic Measures

- Current Arizona Status Compared to Last Year

	December '12	December '13
Annual Jobs Added 10-yr Average = 73,700	50,900	47,500
Pending Maricopa Foreclosures Pre Recession Normal = 3,000	12,000	6,100
Arizona Annual Single Family Permits Pre Recession Normal = 40,000	15,900	17,700
Arizona Underwater Mortgages	39%	22%

Arizona Forecasters Are Optimistic Compared to Many Other Western States

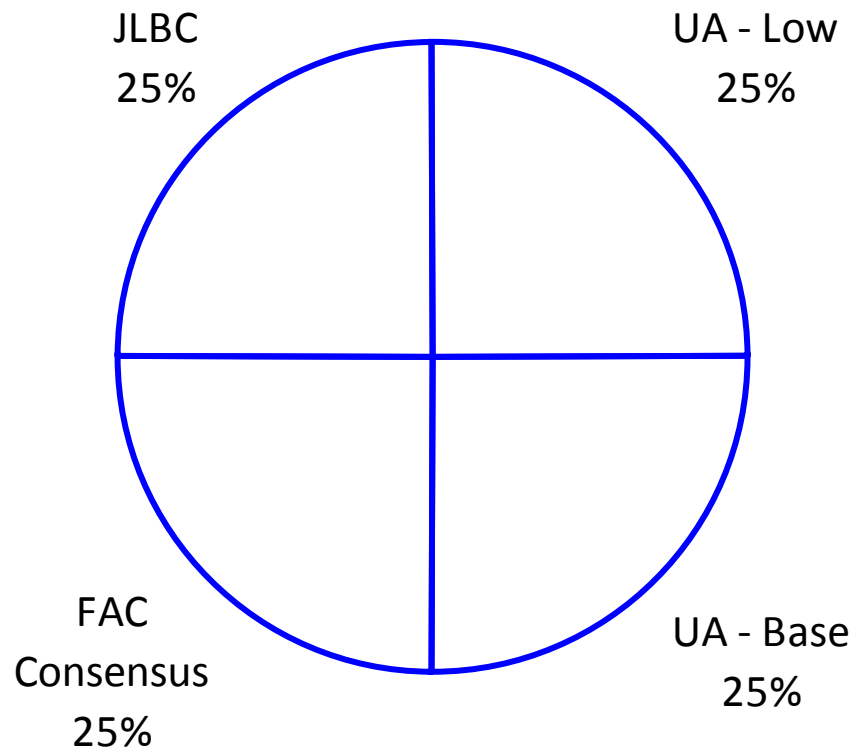
Blue Chip Forecast CY '14 % Personal Income Growth

Texas	5.8%
Washington	5.6%
Utah	5.5%
Arizona	5.2%
California	5.1%
Colorado	5.1%
Oregon	5.0%
Wyoming	4.5%
Montana	4.5%
Idaho	4.2%
New Mexico	4.2%
Nevada	3.2%

Where Are We Headed Over the Next Few Years?

- Four-Sector Consensus Forecast Incorporates Different Economic Views, Including the FAC

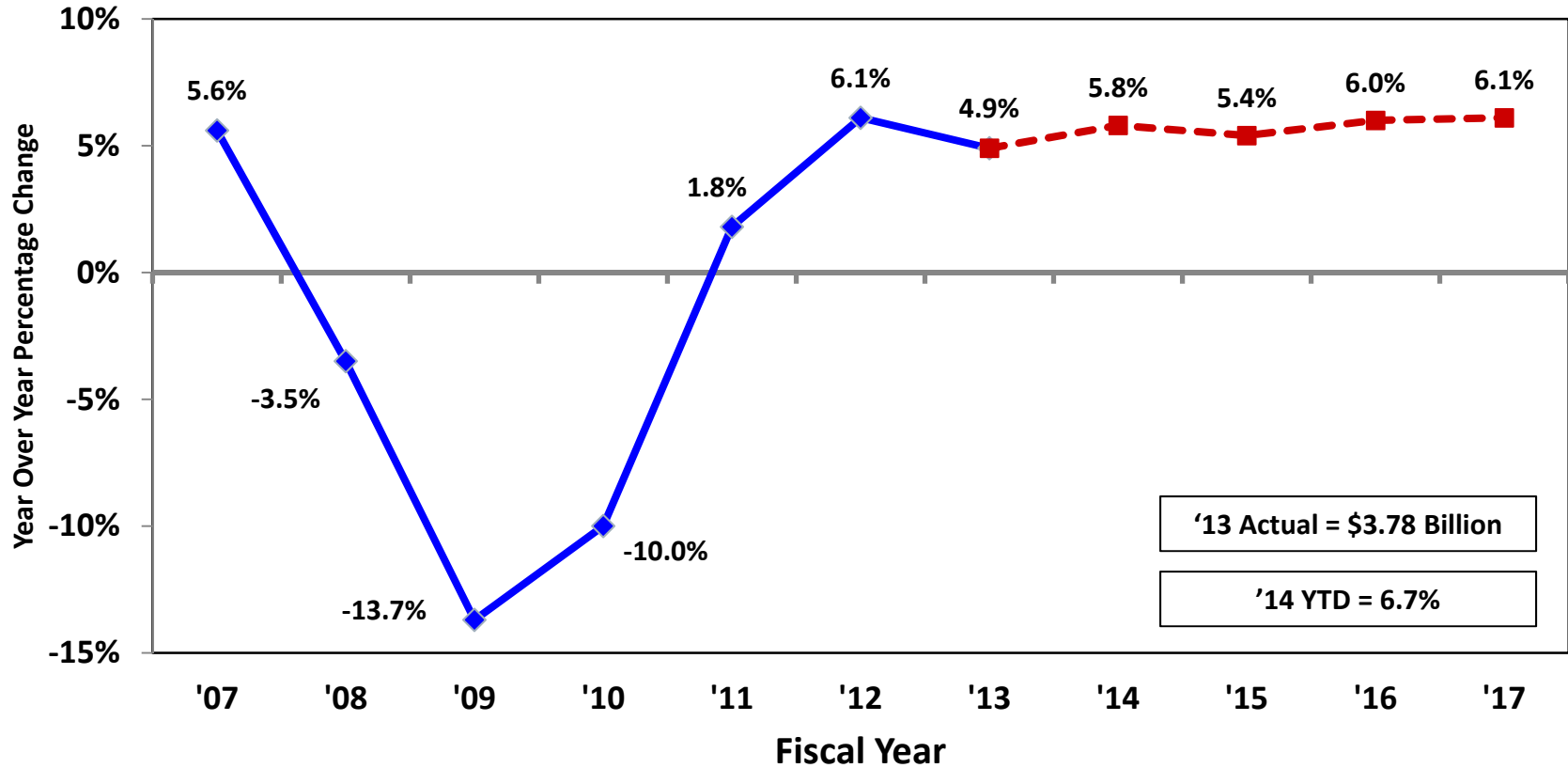
- ❑ 4-sector forecast equally weights:
 - FAC average
 - UofA model – base
 - UofA model – low
 - JLBC Staff forecast
- ❑ Small categories (8%) are Staff forecast
- ❑ Probability of exceeding forecast is 65%



* Includes Big 3 categories of sales tax, individual income and corporate income taxes

Sales Tax

- Projected Growth of 5.8% in FY '14 and 5.4% in FY '15



'13 Actual = \$3.78 Billion
'14 YTD = 6.7%

◆ Historical ■ 4-Sector Forecast

Percent Change in Base Revenue Excluding Tax Law Changes and 1-Cent Sales Tax

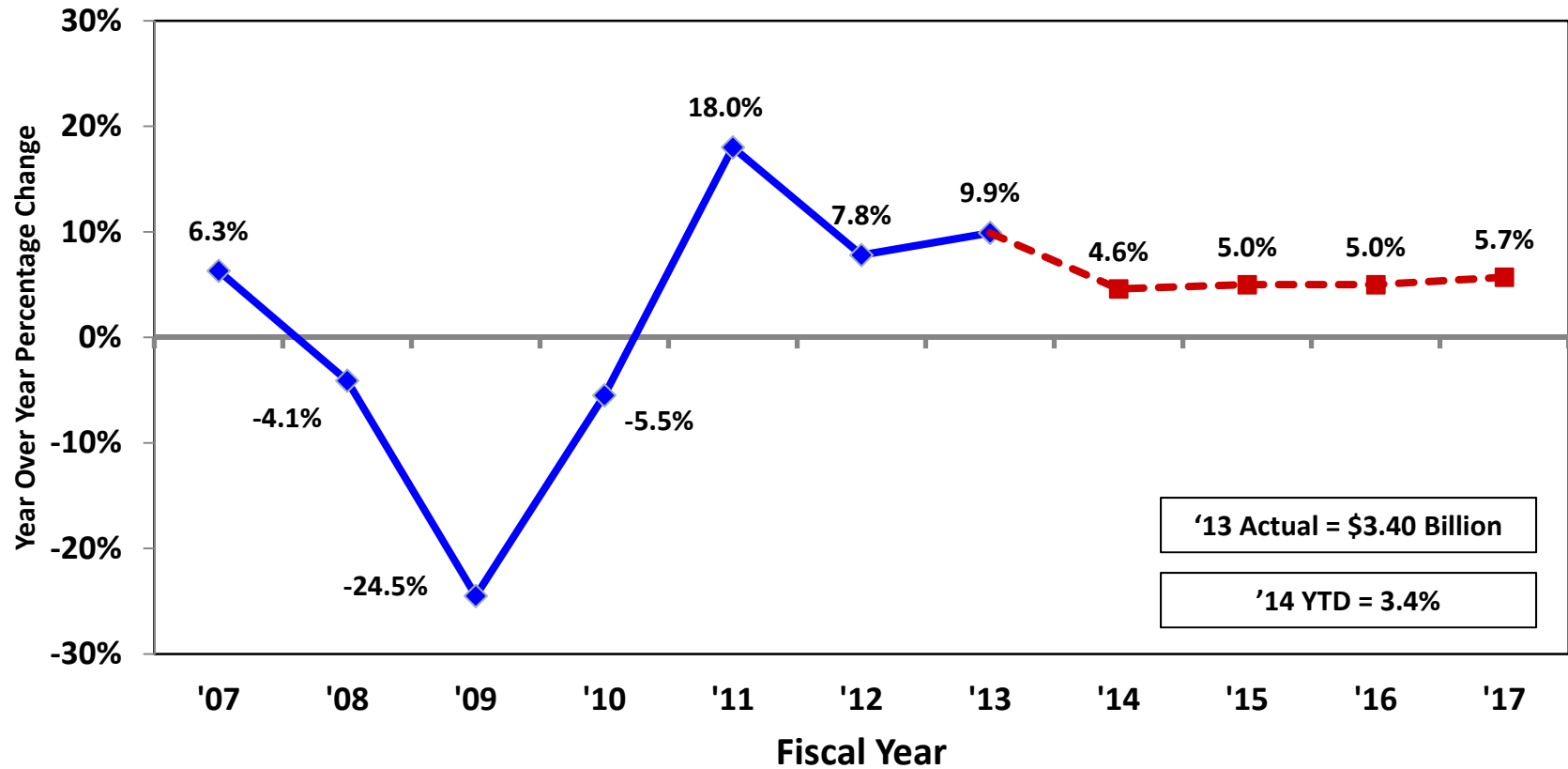


Impact of Taxing Internet Sales Remains Uncertain

- ❑ Arizona, along with 18 other states, already collects sales tax on Amazon purchases
- ❑ Beyond Amazon, impact of an affiliate nexus (“click-through”) tax may generate \$10 M to \$25 M
- ❑ Federal Marketplace Fairness Act would broaden internet sales tax even more
 - NCSL \$700 M estimate includes business to business
 - Likely gain: \$100 M or less

Individual Income Tax

- Projected Growth of 4.6% in FY '14 and 5.0% in FY '15



'13 Actual = \$3.40 Billion

'14 YTD = 3.4%

◆ Historical -■- 4-Sector Forecast

Percent Change in Base Revenue Excluding Tax Law Changes and One-Time Changes



Components of Individual Income Tax Growth

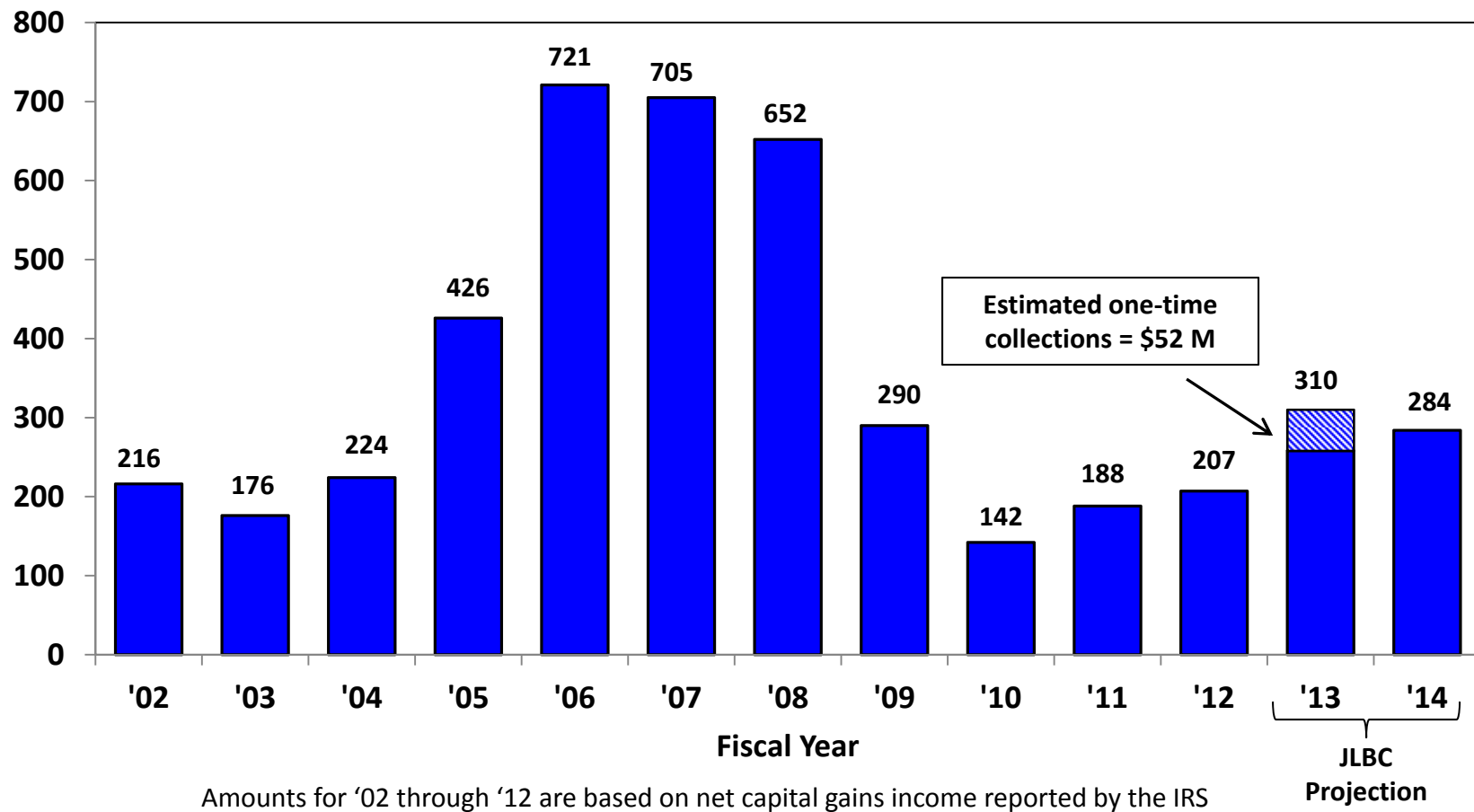
- FY '13 and First Half of FY 14

	<u>FY '13</u>	1 st Half Prelim <u>Actual</u>
Withholding	3.5%	1.7%
Payments	16.3%	15.4%
Refunds	<u>(2.5)%</u>	<u>6.6%</u>
Net	10.1%	3.4%

- ❑ Withholding growth below job and wage growth for 1½ years
- ❑ '13 payment increase partly due to accelerated capital gains
- ❑ '14 payment gain may reflect correction of '13 under payment
- ❑ Will reevaluate '14 growth with more data

Estimated Collections from Capital Gains

- Historically Volatile Component of Revenue

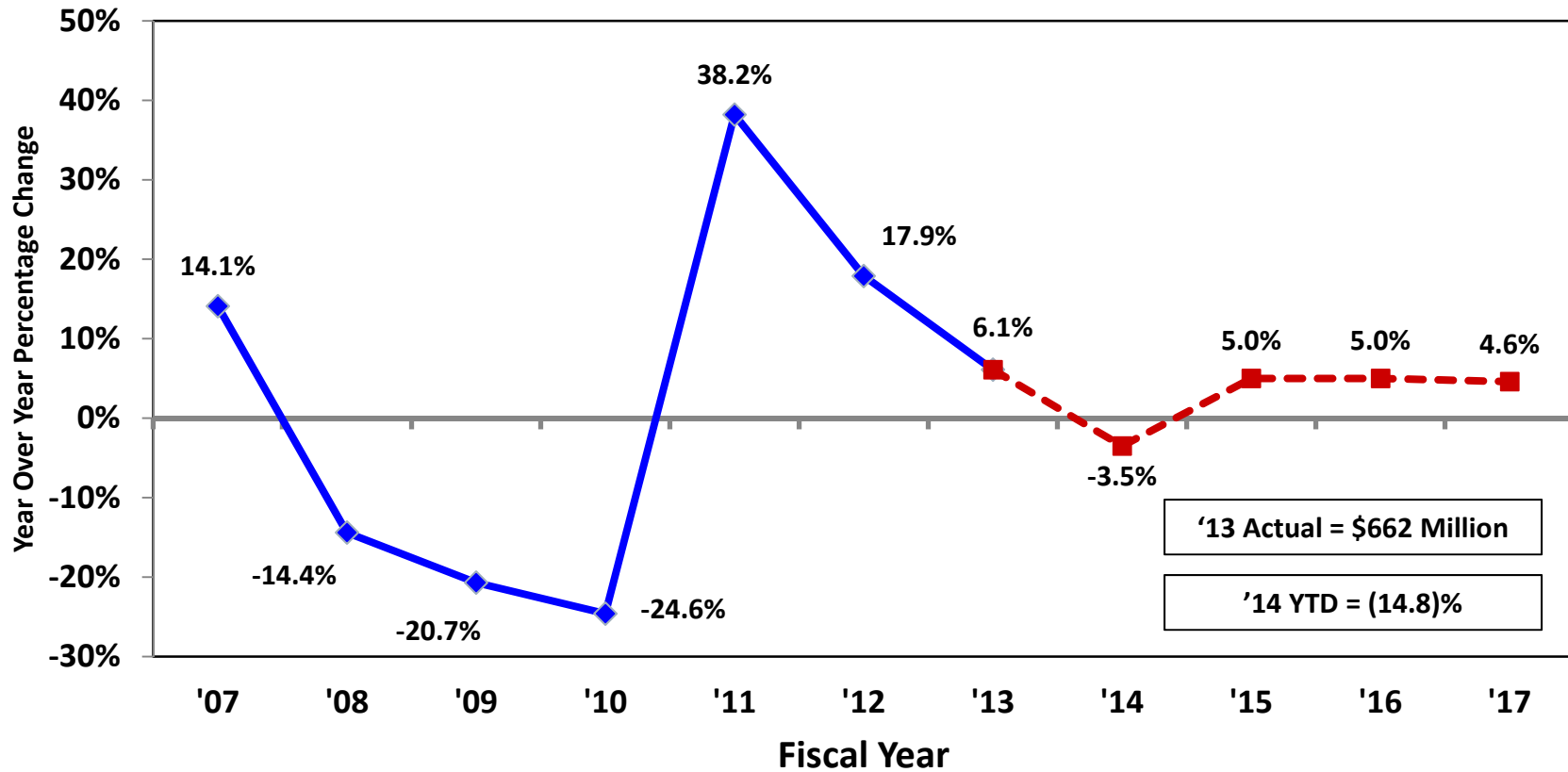


FY '13 Tax Acceleration Likely One-Time

- ❑ Possible and actual federal policy changes incentivized companies to issue dividends and stockholders to take capital gains in December 2012
- ❑ Collections were accelerated into FY '13, likely reducing collections in future years
- ❑ JLBC projections include a \$52 M acceleration of collections into '13 and corresponding reductions of \$(26) M in '14, \$(13) M in '15, and \$(13) M in '16
- ❑ Strong TY '13 stock market performance projected to increase capital gains collections by 20% in FY '14

Corporate Income Tax

- Projected Change of (3.5)% in FY '14 and 5.0% in FY '15

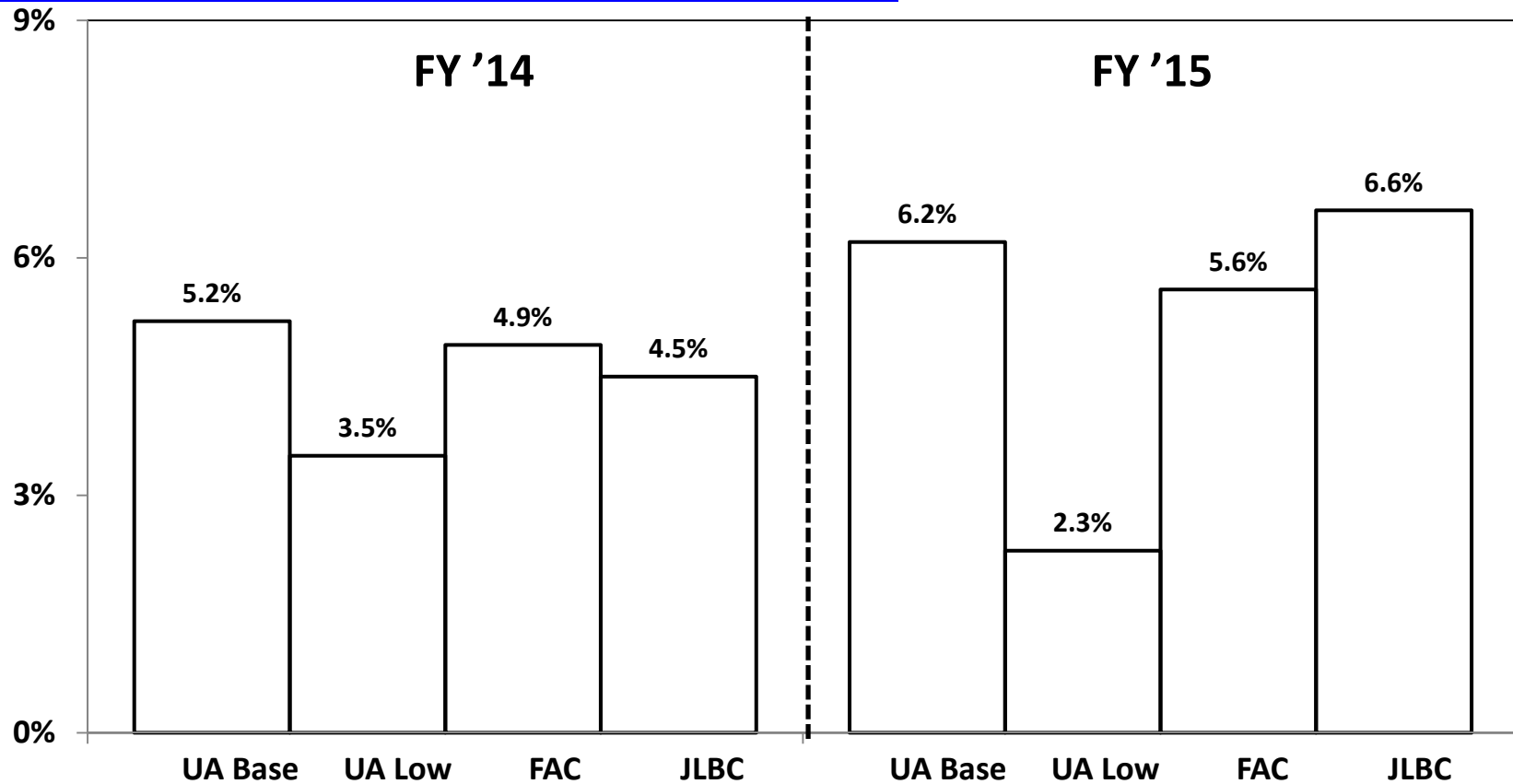


◆ Historical -■- 4-Sector Forecast

Percent Change in Base Revenue Excluding Tax Law Changes and One-Time Changes



Consensus Predicts Base Growth Rate of 4.3% in FY '14 and 5.3% in FY '15*



Details in Appendix A

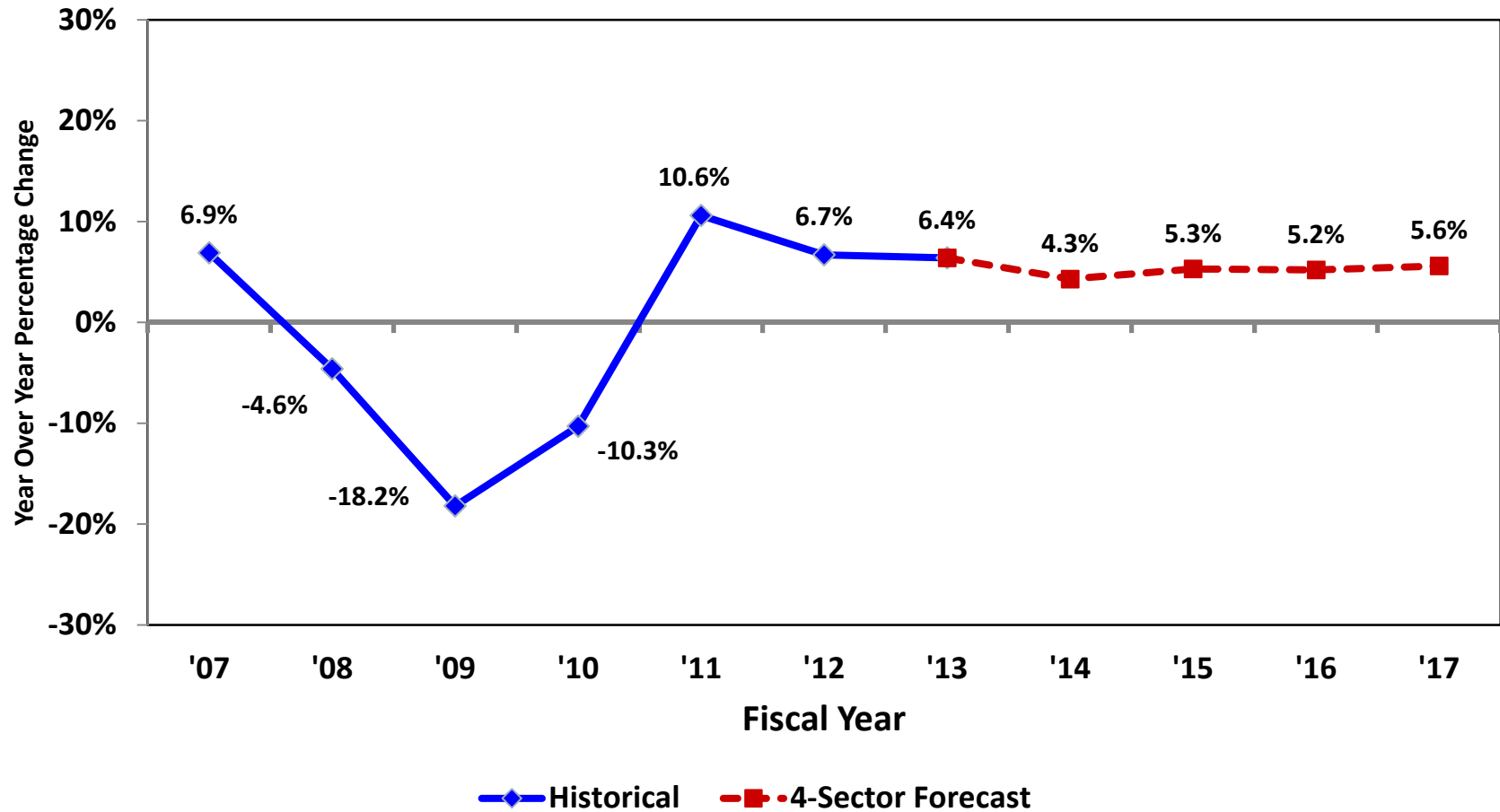
* After adjusting for small tax categories, the base growth rate is 4.3% in FY '14 and 5.3% in FY '15



What Are Risks in Forecast?

- ❑ Standard caveats like unknown events and international economics
- ❑ Will Federal Reserve Board successfully “taper” its purchase of bonds without economic disruption?
- ❑ With 2-year budget agreement, federal fiscal policy poses less risk – but 2 caveats
 - Annual federal tax reduction “extender” bill in limbo
 - Prior defense sequester cuts not yet fully implemented
- ❑ 1% change in annual growth over 3 years has a \$575 M impact on balance sheet

Consensus Forecasts Continuing Moderate Growth Rates Through FY '17



Percent Change in Base revenues excluding balance forward, tax law changes, one-time revenues, and urban revenue sharing

Major Tax Provisions

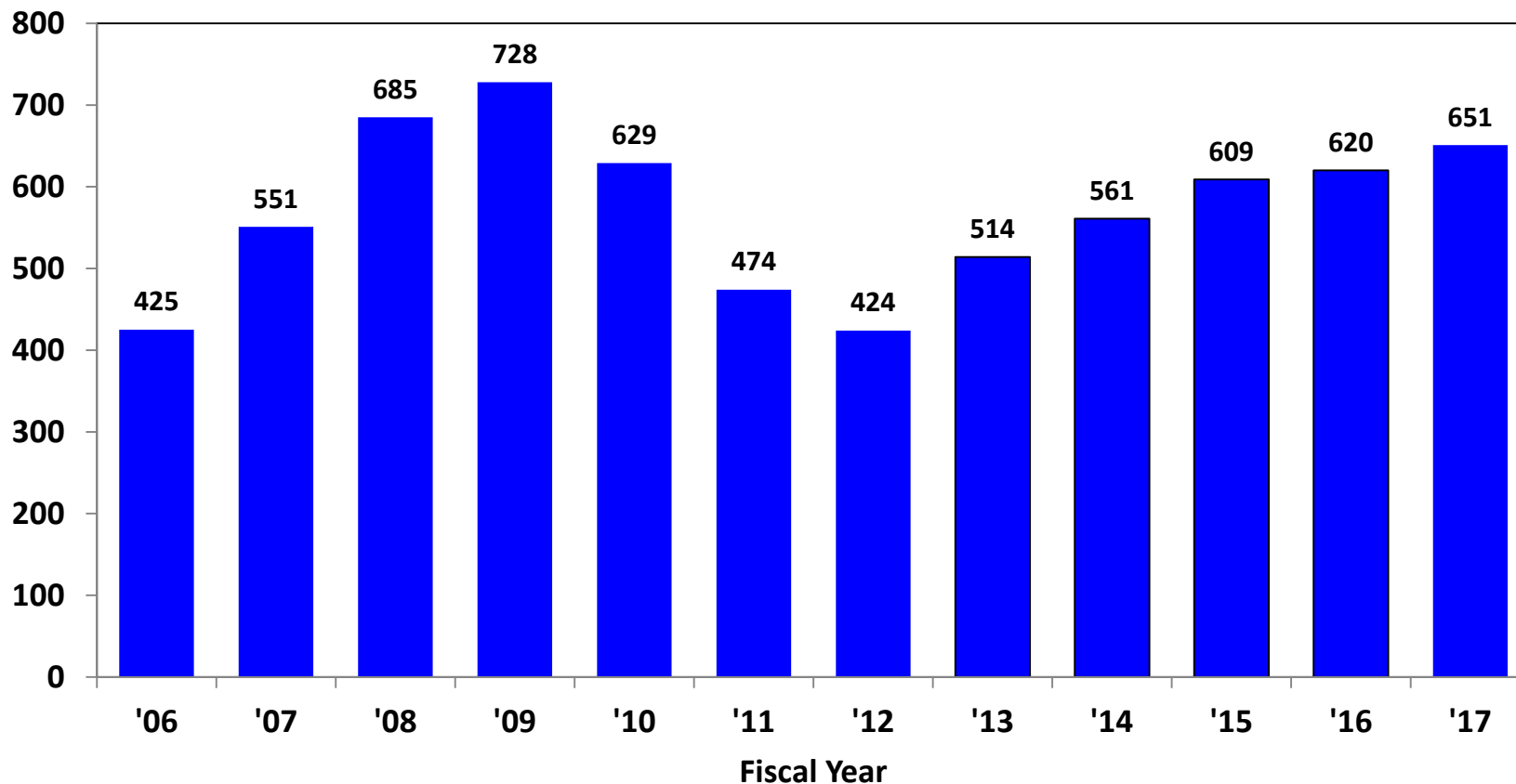
- Enacted, but Delayed Effective Date

Provisions	(\$ in Millions)		
	FY '15	FY '16	FY '17
Corporate Rate Phase Down (FY '15 – FY '18)	50	61	62
Corporate Sales Factor Phase In (FY '15 – FY '18)	39	38	32
Capital Gains Reduction	16	12	7
All Other	24	5	8
Total	129	116	109

All impacts relative to prior year

State Shared Income Tax Will Increase by \$48 M in FY '15

– City Share Linked to Income Tax 2 Years Prior



Based on January forecast, '17 estimate is \$631 M



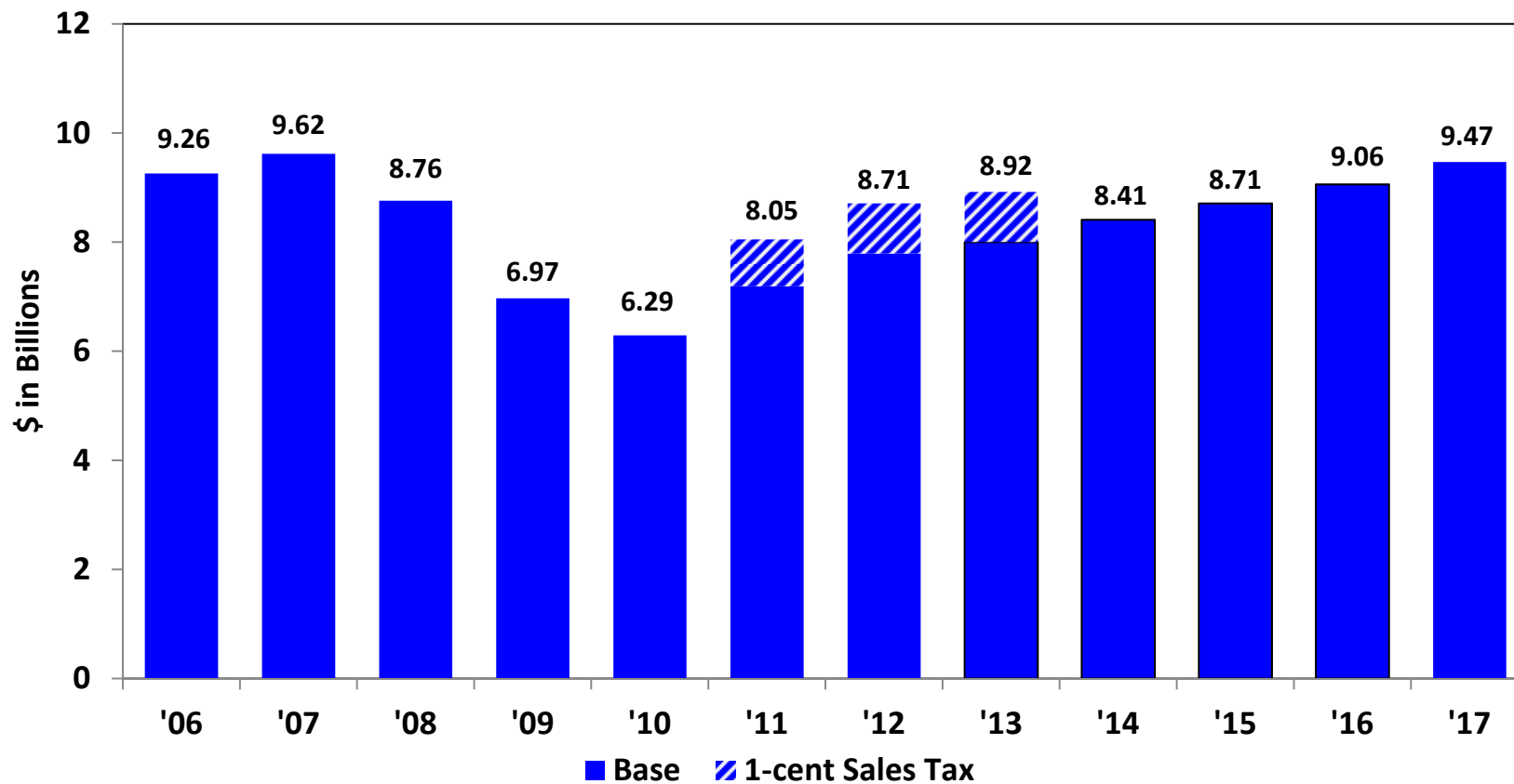
Detail of FY '15 – FY '17 Revenue Changes

- Excludes Change in Beginning Balance

\$ in Millions

	FY '15 Above <u>FY '14</u>	FY '16 Above <u>FY '15</u>	FY '17 Above <u>FY '16</u>
Base Revenue Growth (5.3%/5.2%/5.6%)	477	480	544
Elimination of Fund Transfers	(154)	--	--
Previously Enacted Tax Legislation	(129)	(116)	(109)
Urban Revenue Sharing	<u>(48)</u>	<u>(11)</u>	<u>(31)</u>
Total	146	353	404
Net % Growth	1.7%	4.1%	4.5%

Consensus Forecasts Remain Below FY '07 High



Excludes balance forward and other one-time revenues. Includes tax law changes and Urban Revenue Sharing.



Spending Overview

FY '15 – FY '17 Projected Spending Changes

	General Fund - \$ in Millions		
	<u>FY '15</u> <u>Above '14</u>	<u>FY '16</u> <u>Above '15</u>	<u>FY '17</u> <u>Above '16</u>
K-12 Formula	167	230	303
Medicaid Formula (AHCCCS/DHS)	15	83	93
DES Caseload/Backfill	45	27	29
University Parity	15	15	15
ADC Operating	25	11	3
Comm. Colleges Formula	(4)	2	2
Other	21	2	(3)
Additional Ongoing Spending	284	370	442
One-time Prison Capital	(50)	0	0
Debt Buyback	0	0	210
Total Spending	\$9,036 M	\$9,406 M	\$10,058 M

Projected Ending Balance Estimates

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Updated FY '14 – '17 Budget Projections

Baseline

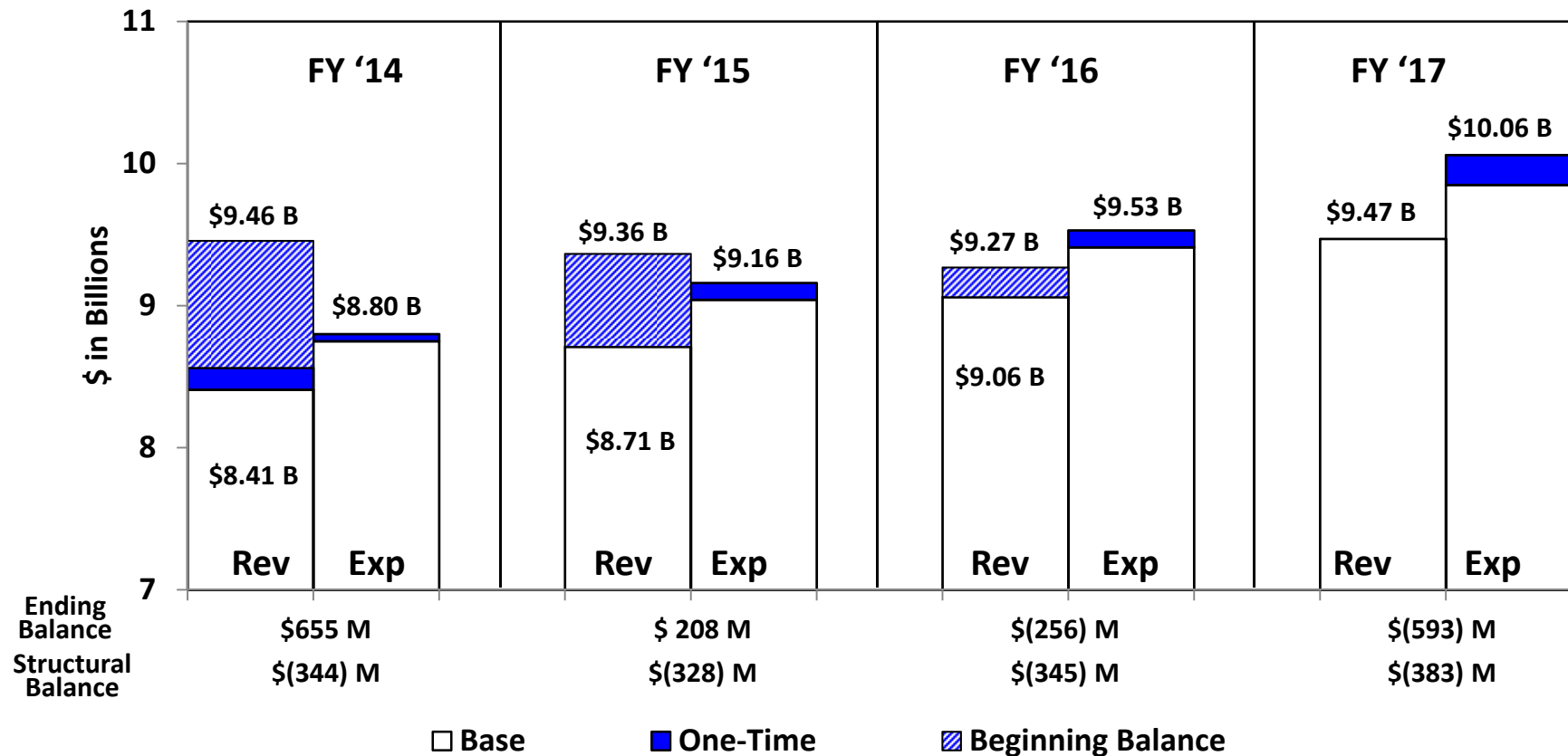
	<u>FY '14</u>	<u>FY '15</u>	<u>FY '16</u>	<u>FY '17</u>	
Balance Forward	\$895 M	\$655 M	\$327 M	\$0	\$(17) M
Baseline Revenues	\$8.56 B	\$8.71 B	\$9.06 B	\$9.47 B	
Baseline Spending	\$8.80 B	\$9.04 B	\$9.41 B	\$10.06 B	
Baseline Balance	\$655 M	\$327 M	\$(17) M	\$(593) M	\$(610) M

Baseline with HURF Proposal

Balance Forward	\$895 M	\$655 M	\$208 M	\$0	\$(256) M
Baseline Revenues	\$8.56 B	\$8.71 B	\$9.06 B	\$9.47 B	
Baseline Spending	\$8.80 B	\$9.04 B	\$9.41 B	\$10.06 B	
HURF Proposal	\$0	\$119 M	\$119 M	\$0	
Adjusted Balance	\$655 M	\$208 M	\$(256) M	\$(593) M	\$(849) M

FY'14 – '17 Revenues Compared to Expenditures

- Baseline Adjusted for HURF Proposal

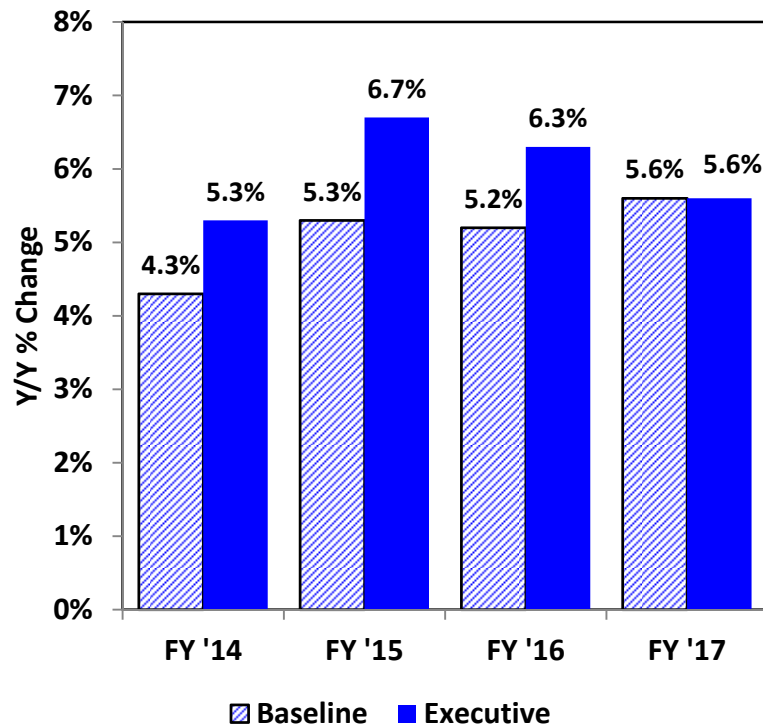


Executive Budget Comparison

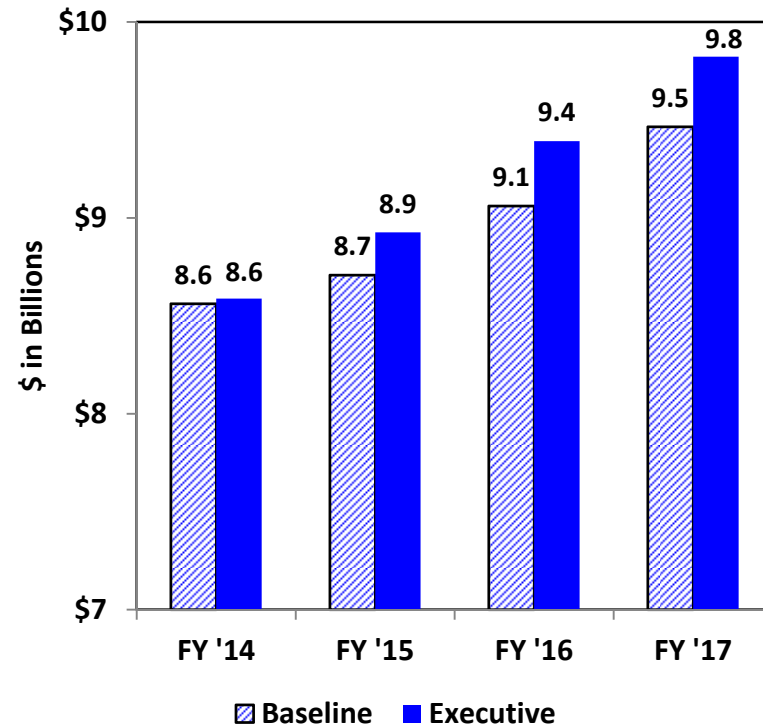
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Executive Revenues Exceed Baseline By \$933 M Through '17

Base Growth Rate

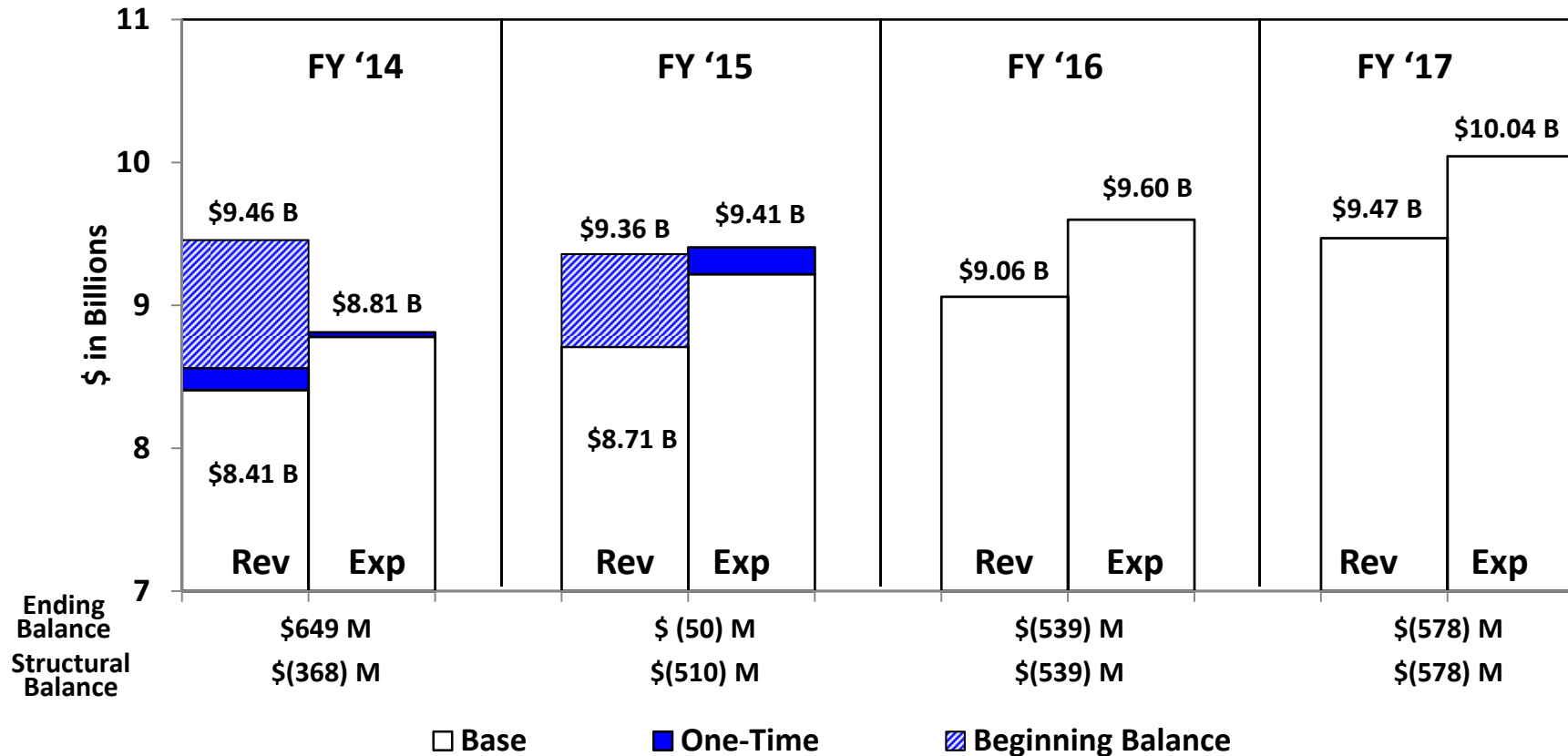


Total Revenue Excluding Balance Forward



Comparing JLBC Revenues with Executive Spending

- Use JLBC K-12 and Medicaid Technical Estimates
- Exclude HURF Shift/Debt Buyback



FY '17: How JLBC's \$(849) M Shortfall Becomes Executive's \$421 M Surplus

<u>\$ in M</u>	
\$(849)	Baseline '17 shortfall
933	Higher Executive revenue – '14-'17
647	Lower Executive K-12 and Medicaid technical estimates – '15-'17
448	Executive removes HURF shift/debt buyback
<u>(758)</u>	Executive higher spending – '14-'17
\$ 421	Executive '17 Balance

Appendix A: January 2014 4-Sector Forecast

	<u>FY 2014</u>	<u>FY 2015</u>	<u>FY 2016</u>	<u>FY 2017</u>
Sales Tax				
JLBC Forecast	6.5%	6.0%	6.1%	6.2%
UA – Low	4.4%	2.7%	4.7%	5.6%
UA – Base	6.2%	6.6%	7.2%	7.1%
FAC	6.2%	6.1%	5.8%	5.5%
Average:	5.8%	5.4%	6.0%	6.1%
Individual Income Tax				
JLBC Forecast	4.5%	6.3%	5.9%	6.2%
UA – Low	3.0%	2.3%	3.0%	5.2%
UA – Base	4.7%	5.3%	5.4%	5.9%
FAC	6.3%	6.0%	5.5%	5.4%
Average:	4.6%	5.0%	5.0%	5.7%
Corporate Income Tax				
JLBC Forecast	(7.0)%	11.9%	4.1%	5.5%
UA – Low	0.9%	0.2%	1.9%	2.4%
UA – Base	1.9%	8.4%	8.1%	4.7%
FAC	(9.7)%	(0.4)%	5.6%	5.8%
Average:	(3.5)%	5.0%	5.0%	4.6%
JLBC Weighted Average	4.5%	6.6%	5.9%	6.2%
UA Low Weighted Average	3.5%	2.3%	3.8%	5.3%
UA Base Weighted Average	5.2%	6.2%	6.5%	6.4%
FAC Consensus Weighted Average	4.9%	5.6%	5.6%	5.5%
“Big-3” Weighted Average	4.5%	5.2%	5.5%	5.8%
Consensus Weighted Average*	4.3%	5.3%	5.2%	5.6%
Adjusted Consensus Weighted Average**	3.6%	3.9%	3.9%	4.5%
* Adjusted for small revenue categories				
** Adjusted for tax law changes				