Revenue and Budget Update

Arizona Tax Research Association

November 20, 2015

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Summary of Current Budget Status

- JLBC Baseline reflects revenue and statutory funding formula growth
- The projected '17 <u>one-time</u> cash balance is $555M
- Up to $218M available for permanent initiatives without re-creating a long-run structural gap
- Remember lessons learned from the '08 budget

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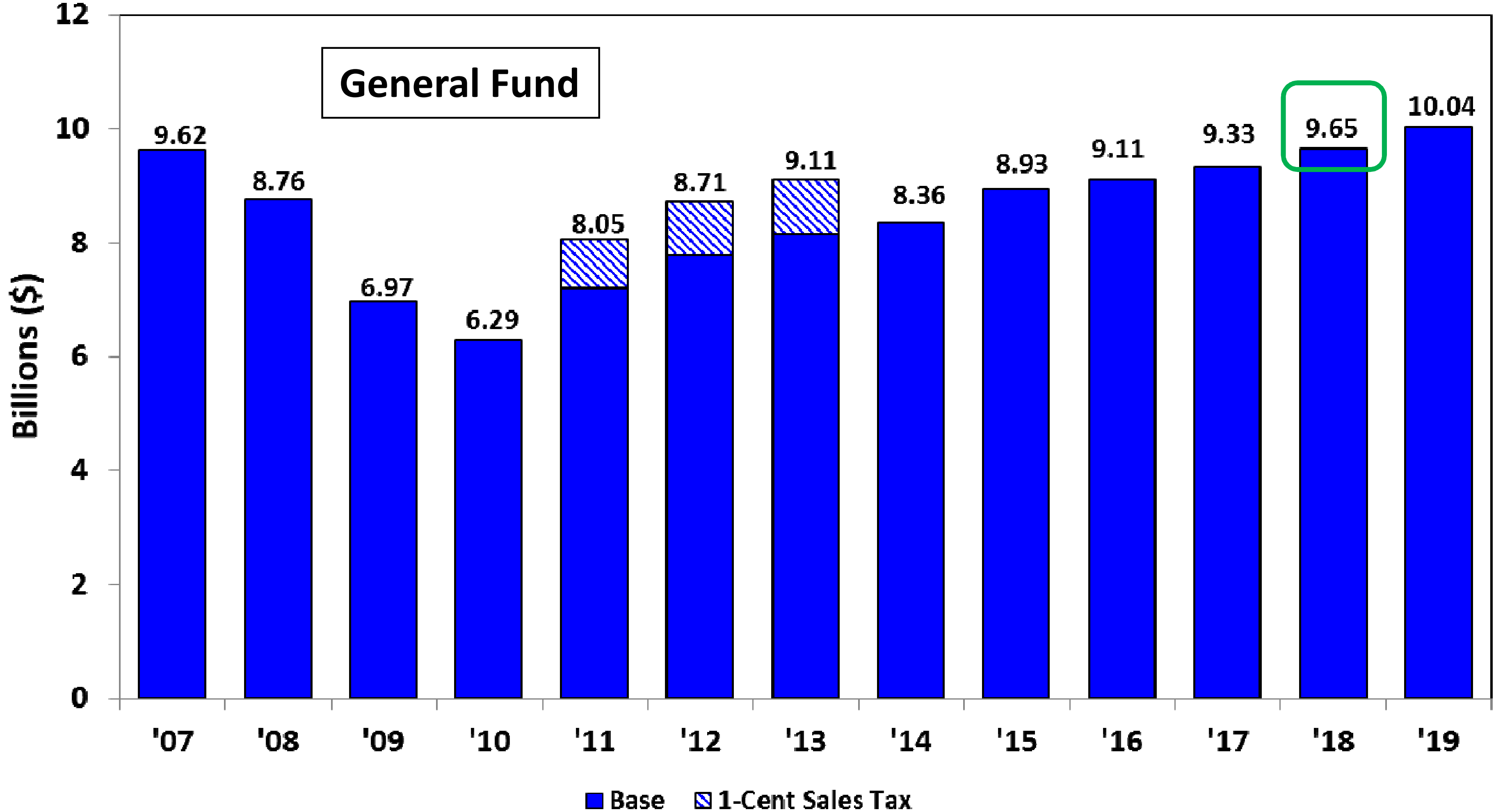
Revenue Will Reach Pre-Recession Level in ’18



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

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Forecast Risks
- 1% Variance Yields $600 M Over 3 Years

Potential Gains

- National recovery creating more interstate migration

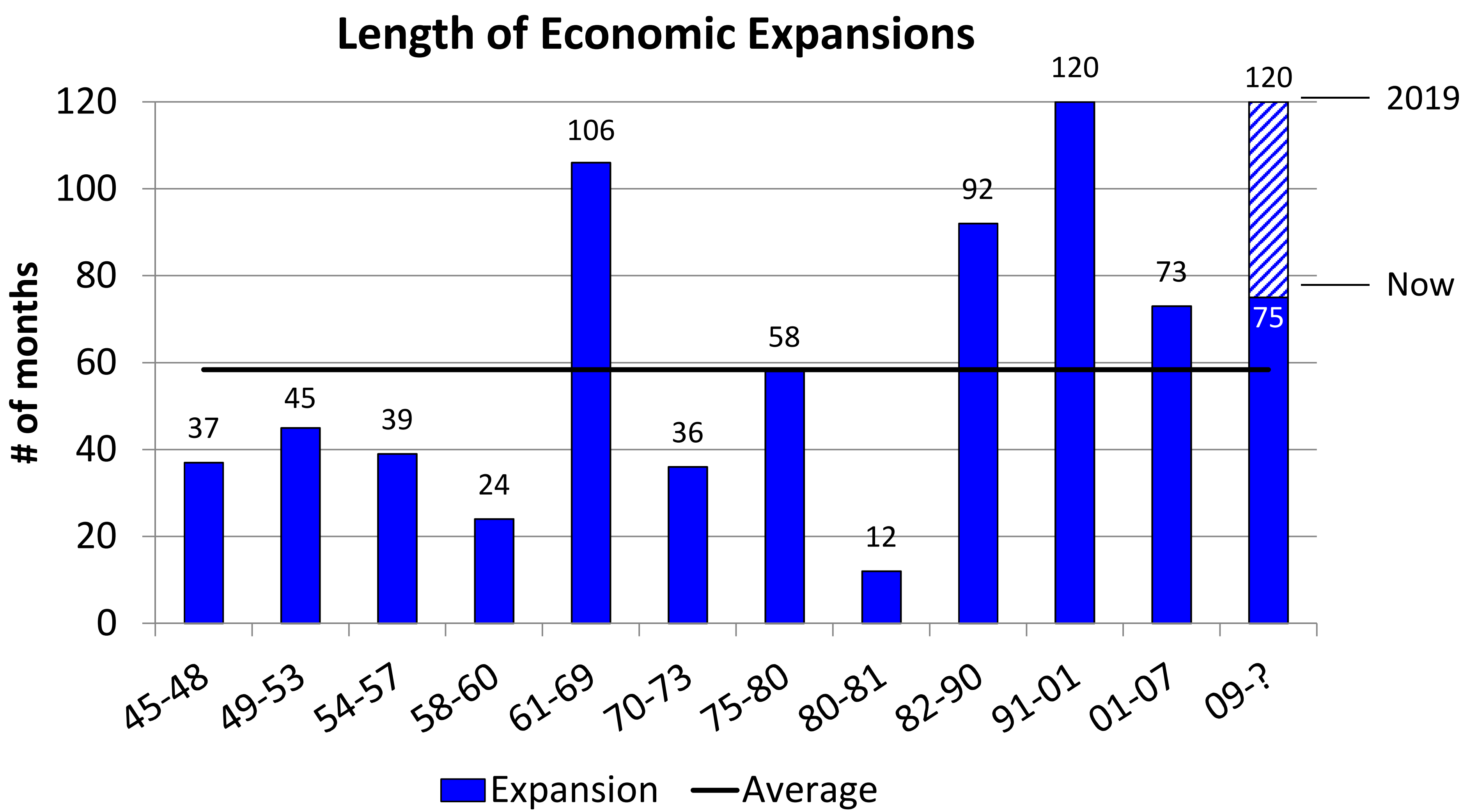
Potential Gain or Loss

- Estimate of ongoing ’15 gains

Potential Losses

- If historical average holds true, recession likely in this forecast cycle

Current Expansion Exceeds Historical Average



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1st Trimester Net Revenue Growth Slowed Significantly

- ’15 Driven by Capital Gains and Corporate Taxes

	’15 Above ’14	Thru Oct. Above ’15
Sales	4.7%	2.5%
Individual Income	8.6%	5.3%
Corporate Income	15.3%	(4.7%)
Other	(14.5%)	3.2%
Total	**6.1%**	**3.3%**

- 1st trimester includes $46 M in tax amnesty collections, $31 M more than expected
- Without amnesty, 1st trimester is $90 M above forecast
- “Core” revenue growth remains disappointing --2.5% for sales, 1.2% for withholding

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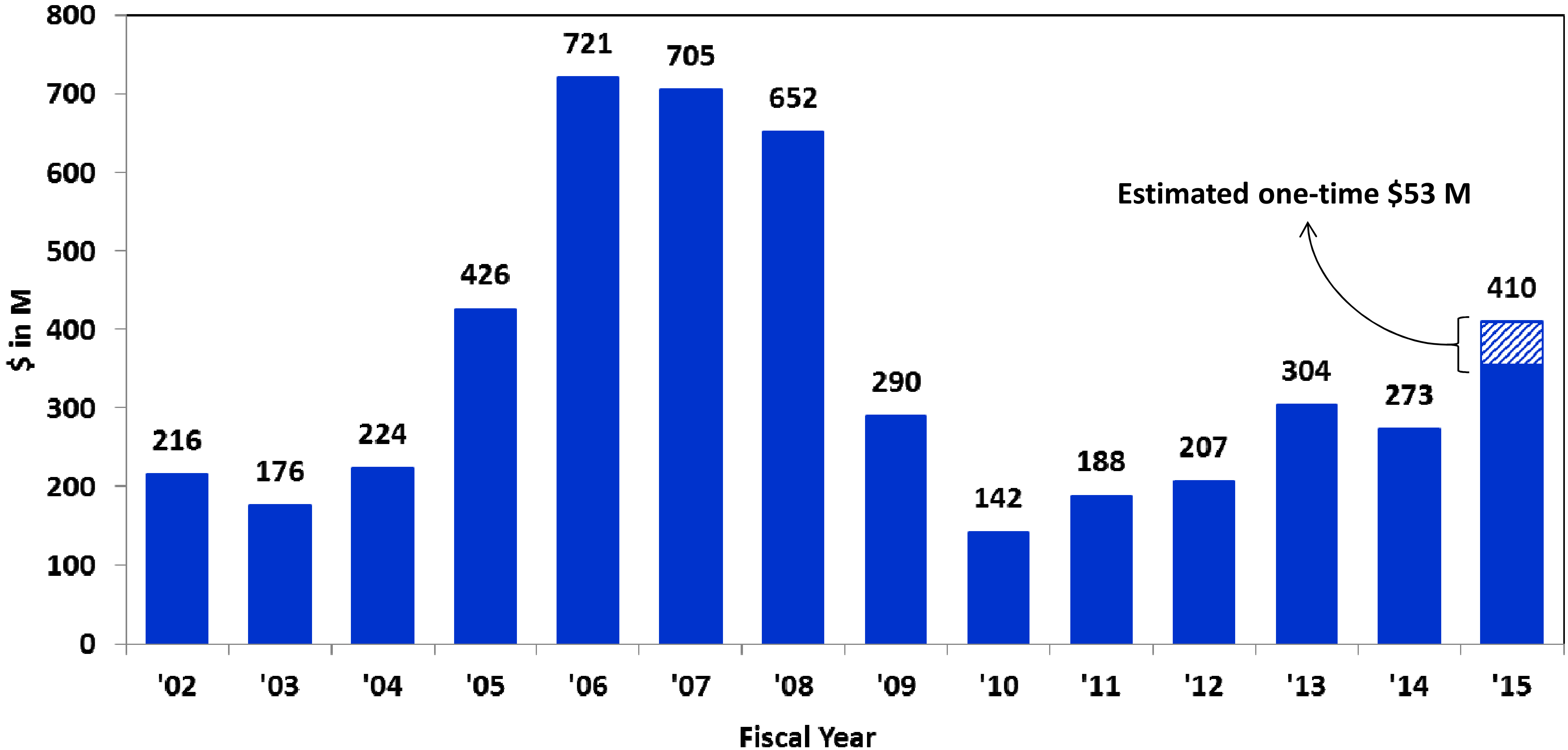
Volatility of Capital Gains Complicate Forecasting

- Final '15 Capital Gain Receipts to be Determined



Individual Income Tax Capital Gains Revenue

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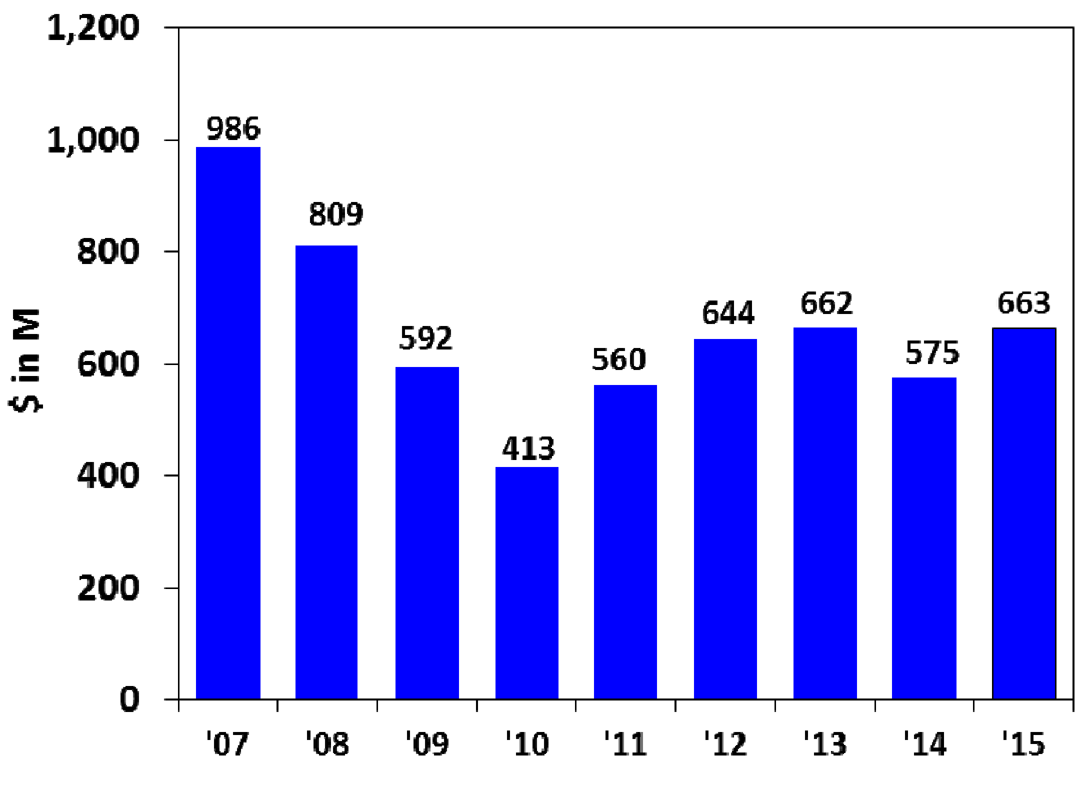
Corporate Gains May Not Be Sustainable
- Past History of Significant Revenue Shifts



Corporate Income Tax Collections

- In 22 of last 28 years, annual change has been > +/- 10%
- ’14 & ’15 results inexplicable
- 4-year tax cut was to begin in ’15, likely delayed to ’16
- YTD ’16, however, only declined by $(8) M

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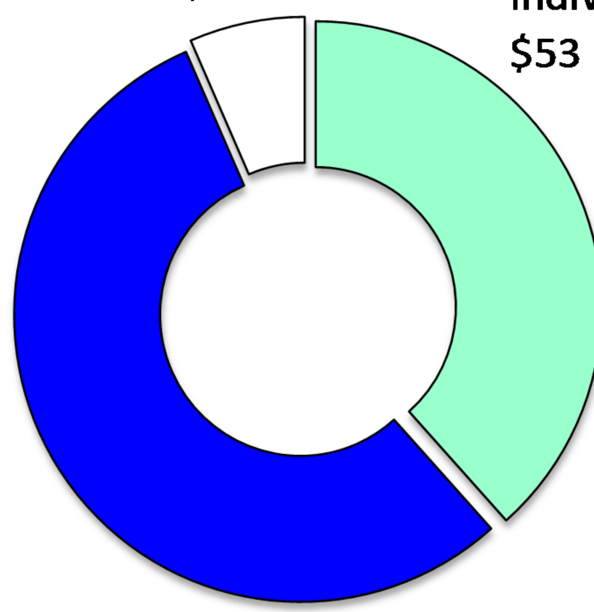
’15 Base Adjusted for One-Time Collections
- Net ’16 Growth with Adjustment is 2.6%

- Some ’15 corporate and capital gains appear one-time
- As a result, a portion of the $378 M ’15 revenue gain is one-time
- FAC Panel average:
  - $240 M ongoing
  - $138 M one-time



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Revenue Growth Accelerates Slightly in ’18 & ’19

October Consensus Forecast

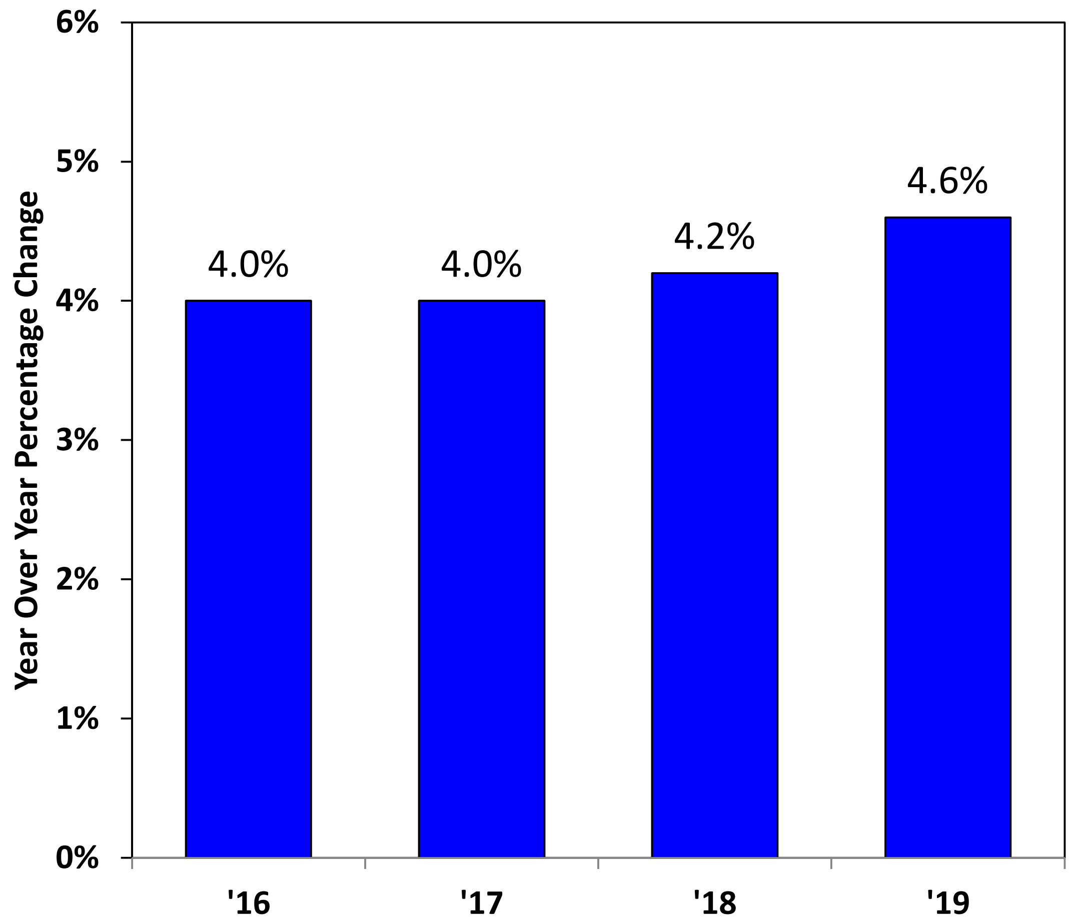
- 4 inputs

Chance of Exceeding Forecast

- 65%

Long Run Average Growth

- 4.75%



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

‘16 adjusted for one-time revenues

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Components of the Revenue Forecast
- Excludes Change in Beginning Balance

$ in M

	’16	’17	’18	’19
Base Revenue Growth (4.0%/4.0%/4.2%/4.6%)	379	388	422	469
Previously Enacted Tax Legislation	(98)	(97)	(90)	(73)
Other Adjustments	57	(206)	(106)	(12)
Total	**338**	**85**	**226**	**384**
% Change	**3.7%**	**0.9%**	**2.4%**	**4.0%**

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Projected Baseline Spending Changes
- Including Special Session

	$ in M Above Prior Year		
	’17	’18	’19
K-12	65	157	142
AHCCCS	81	79	100
DCS	(8)	0	0
DES	15	25	30
Corrections	25	7	0
Universities	12	4	0
Hiring Freeze / Consolidations	(21)	0	0
Employee Health Insurance	(16)	0	0
Land Dept. Self-Fund	0	(13)	0
Other	(14)	(5)	(31)
Total Operating Budget Changes	**140**	**254**	**241**
Total Spending	**$9,322**	**$9,576**	**$9,818**
% Change	**1.4%**	**2.7%**	**2.5%**

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’17: Large Cash Balance, But only Small Structural Balance

- ’17 would be first structurally balanced budget since ’06
- Using $555M cash balance for ongoing initiatives re-creates structural gap
- Excludes $460M Rainy Day Fund Balance

FY 2017 Baseline Projection

	$ in M
Balance Forward / Other One-time Revenues	$ 551
Ongoing Revenues	9,326
Ongoing Spending	(9,322)
Cash Balance	$ 555

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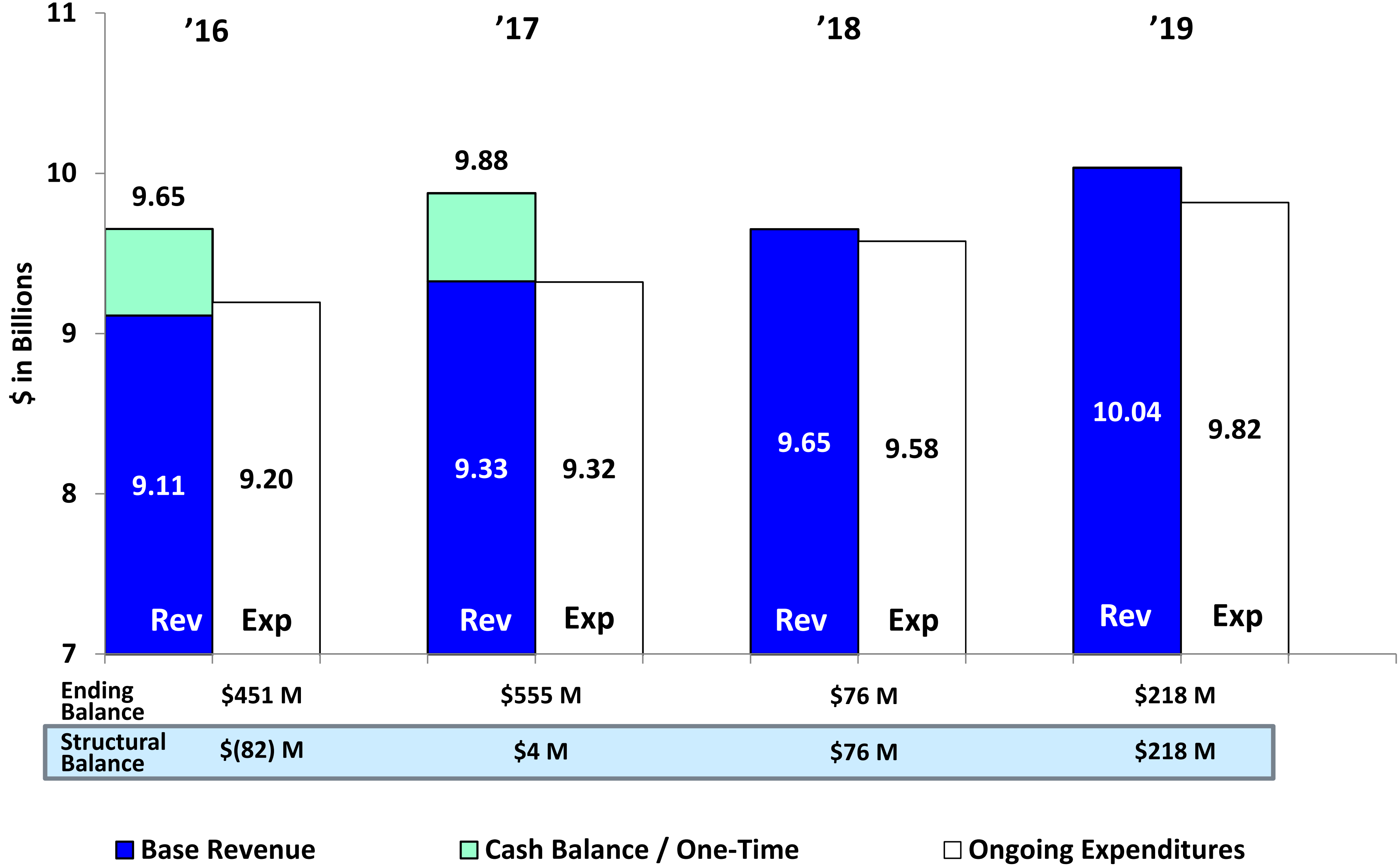
Projected General Fund Revenues & Expenditures
- With K-12 Special Session Funding



	'16	'17	'18	'19
Ending Balance	$451 M	$555 M	$76 M	$218 M
Structural Balance	$(82) M	$4 M	$76 M	$218 M

FY 2017 projected ending balance assumed to be allocated as part of the budget process.

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Agency Budget Requests

	$ in M ’16	’17
DCS	65	106
ADC	-	67
DES (Non-Medicaid)	8	56
SFB	15	27
Universities	24	170

- ’16 represents supplemental to existing budget
- ’17 represents change to enacted ’16 budget

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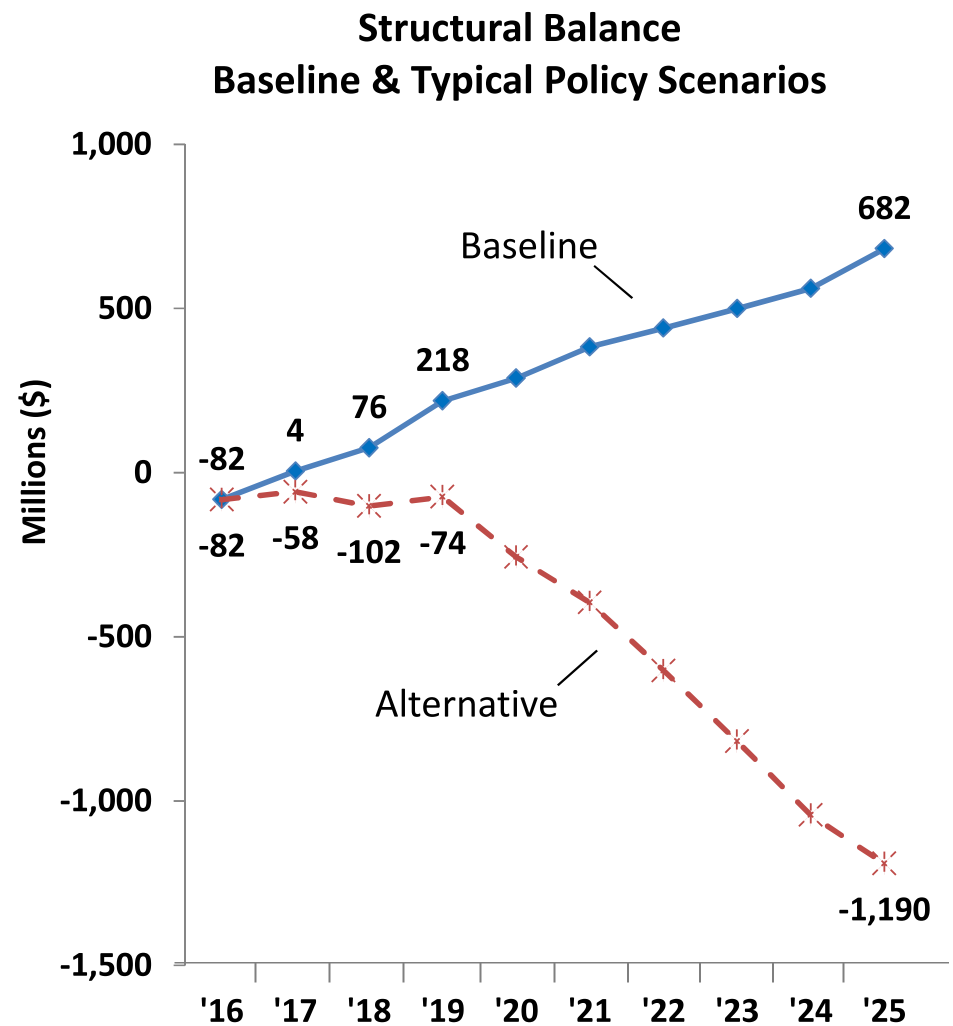
By '25, $680 M Structural Balance Under Baseline, $(1.2) B Shortfall Under Alternative Scenario

- Are 10 year forecasts useful?
- Baseline tends to overstate balances
- Alternative: adds discretionary spending + 10 year average tax cut



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Reviewing JLBC's November 2014 Fiscal Policy Goals

- Discussed at Last Year's ATRA Meeting

- Eliminate structural shortfall
- Develop multi-year solution with targets - Reduce reliance on 1-time solutions over time
- Long term goal: set aside 1-time revenues
  - Excess ending balances
  - Excess capital gains
- Dedicate 1-time $ for 1-time purposes
  - Rebates
  - Operating debt buyback - $84 M annual debt payment
  - Infrastructure
  - IT Modernization

Public Safety Retirement Reform

ATRA 2015 Outlook Conference

November 20, 2015

Leonard Gilroy

Reason Foundation

Reason

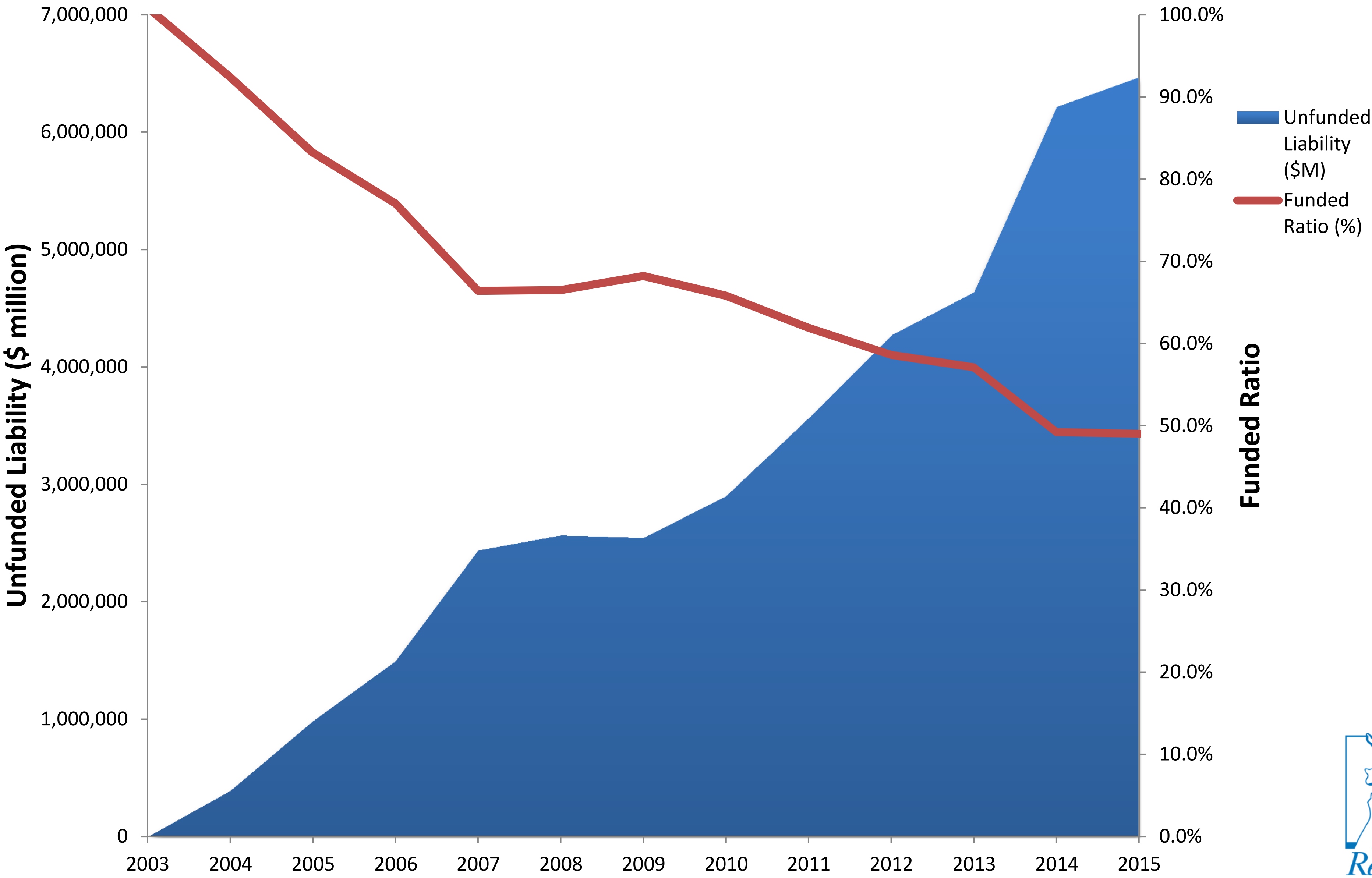
PSPRS Challenges

- PSPRS pension plan has seen massive reduction in funded status, increase in unfunded liabilities over last decade.
- Employer costs (state agencies, local police and fire) are skyrocketing.
- Cities like Bisbee, Prescott are facing massive unfunded liabilities that threaten services, budgets.
- Courts have struck down some previous legislative reforms, with more under litigation.

Reason

PSPRS' Degrading Solvency

Funded Ratio: 101% in FY03 -- 49% in FY14
Unfunded liability: $0 in FY03 -- $6.5 billion in FY14

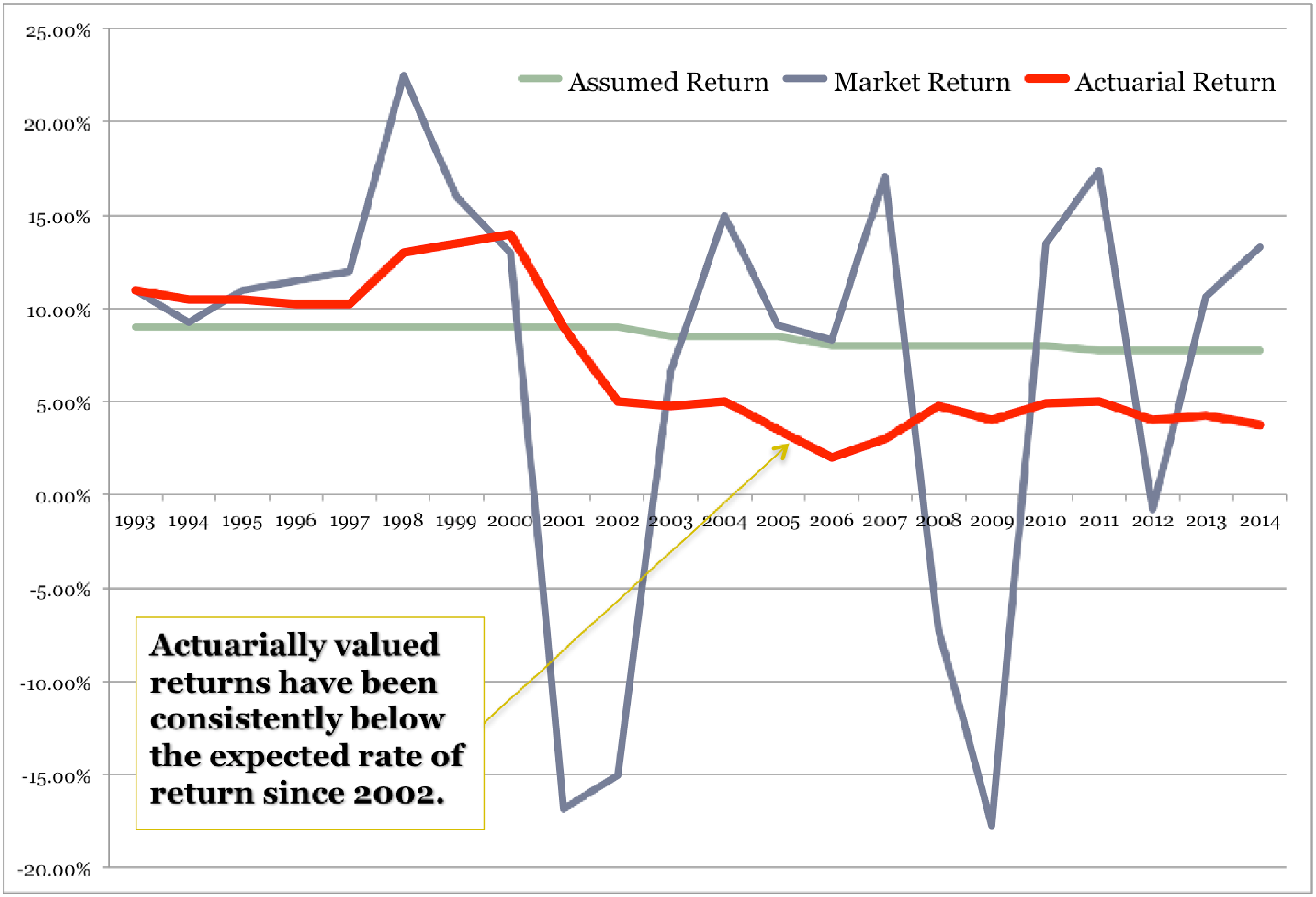


Two Major Problems Impacting PSPRS's Funded Status

- Permanent Benefit Increases (PBI): mostly automatic increases to retiree benefits (e.g., COLA)
  - For retirees before 2011, 50% of "excess" returns over 9% diverted to separate PBI fund
  - Diverted funds cannot be used to reduce unfunded liabilities
  - PBI benefit not pre-funded like a traditional pension COLA
  - PBI benefits compounded, not tied to inflation
  - For retirees after 2011, returns would need to exceed 10.5% and no PBI unless funded ratio >60%
- Underperforming Investment Returns

Reason

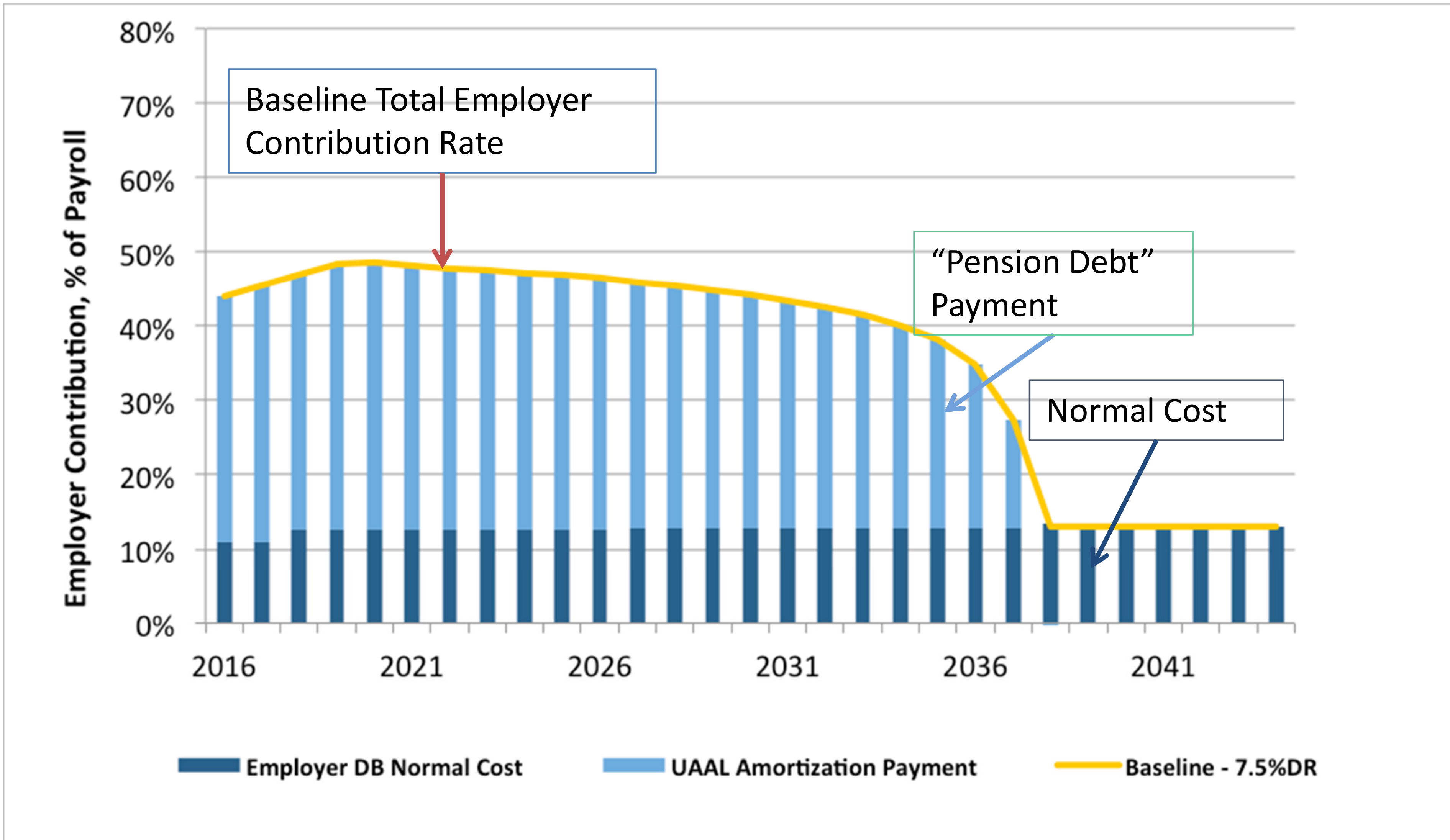
Underperforming Investment Returns



Source: *PSPRS Presentation*, "The Past, Present, and Future of PSPRS: An Educational Employer Seminar," February 2015

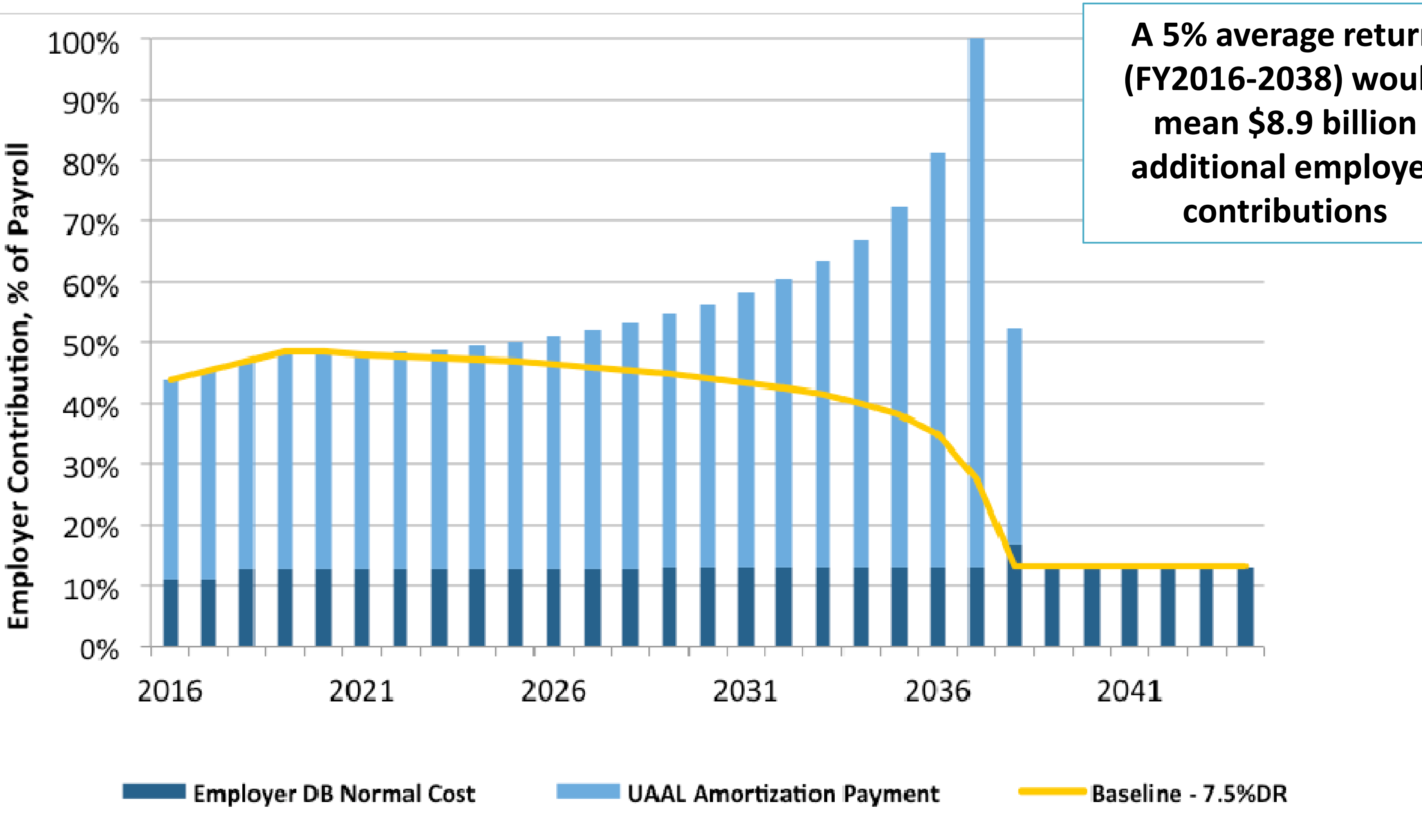
Reason

PSPRS Baseline: Employer Contribution as % of Payroll



PSPRS Employer Contributions in 5% Return Underperformance Scenario

A 5% average return (FY2016-2038) would mean $8.9 billion additional employer contributions



The light blue bars above the yellow line represent $8.9 billion in *additional* pension debt payments for taxpayers if returns are just 5.0% instead of the expected 7.5%.

Reason

Costs and Risks of Inaction

- Rising employer contribution rates = more $$ to pensions, crowding out other public services
- Inability to hire new public safety workers
- Inability to raise public safety wages
- New tax & debt proposals (e.g., failed Prescott PSPRS tax, pension obligation bonds)
- Service-level insolvency
- Municipal bankruptcy

Reason

Current Reform Efforts

Ongoing, collaborative stakeholder process:

- Legislative pension workgroup (led by Sen. Lesko & Rep. Olson)
- Public safety associations (led by Professional Firefighters of Arizona)
- League of Cities & Towns pension reform task force and PSPRS reform “yardstick”
- Reason Foundation (policy options and actuarial support)
- Goal is legislation for 2016 session

Reason

Goals of Reform

Establish a retirement system that is affordable, sustainable, and secure:

- Provide retirement security for members (current and future) and retirees
- Reduce taxpayer and pension system exposure to financial and market risk
- Reduce long-term costs for employers/taxpayers and employees
- Stabilize contribution rates
- Ensure ability to recruit 21st century employees
- Improve governance

Major Reform Concepts Under Discussion

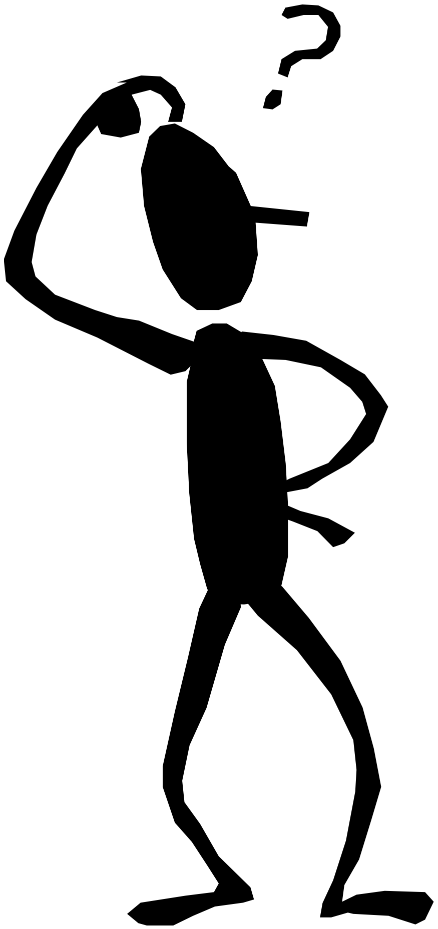
- Constitutional amendment revamping PBI/COLA for retirees, current workers
- New tier for new hires:
  - Hybrid system for new hires with defined-benefit and defined-contribution elements, and employee choice
  - Changes to benefit formula
  - Comparable replacement income for future employees/retirees as today
  - Equal cost sharing between employers and employees
    - Employees currently capped at between 7.65-11.65% of payroll
    - Employers/taxpayers currently bear all costs and risks above that
  - Sustainable COLA structure, pre-funded and limited to inflation
- Reforms to prevent pension spiking
- Governance reforms
- Important to note:
  - Current unfunded liabilities would be reduced somewhat, but significant pension debts would remain and still need to be paid off.
  - Goal with reform is to reduce exposure to risk of future unfunded liabilities and reduce contribution rate volatility.

Reason

Takeaways

- The status quo is unsustainable. The problem is severe, taxpayers bear too much risk.
- Even strong markets will not solve this problem.
- Had the kinds of reform under discussion now been in place a decade ago, it is unlikely that PSPRS would have accumulated over $6 billion in unfunded pension debt.
- With labor and employers at the table, there is a potentially historic opportunity for meaningful reform and a national model for public safety pension reform.

Reason



QUESTIONS?

Leonard Gilroy

leonard.gilroy@reason.org

(713) 927-8777

@lengilroy

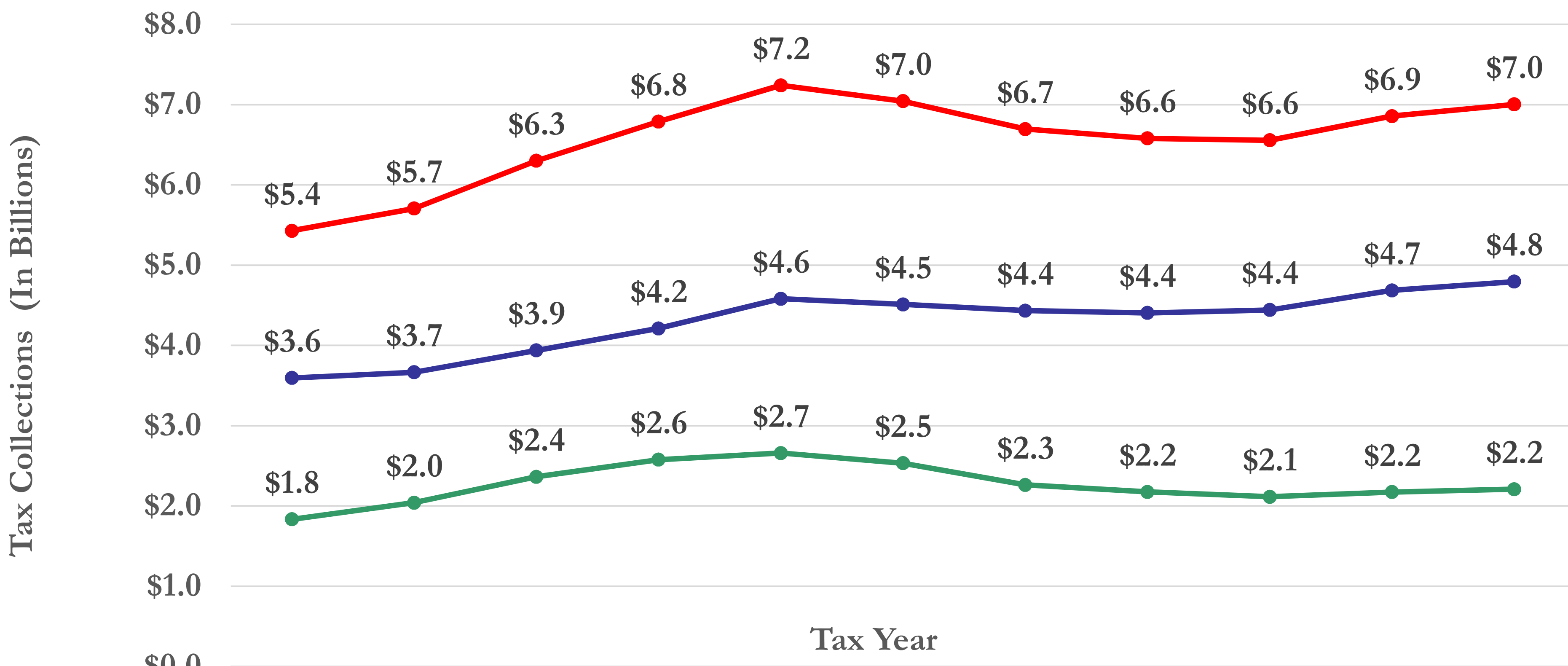
reason.org

Reason

2016 Tax Policy Outlook

ATRA Staff

10-Year Property Tax Levies

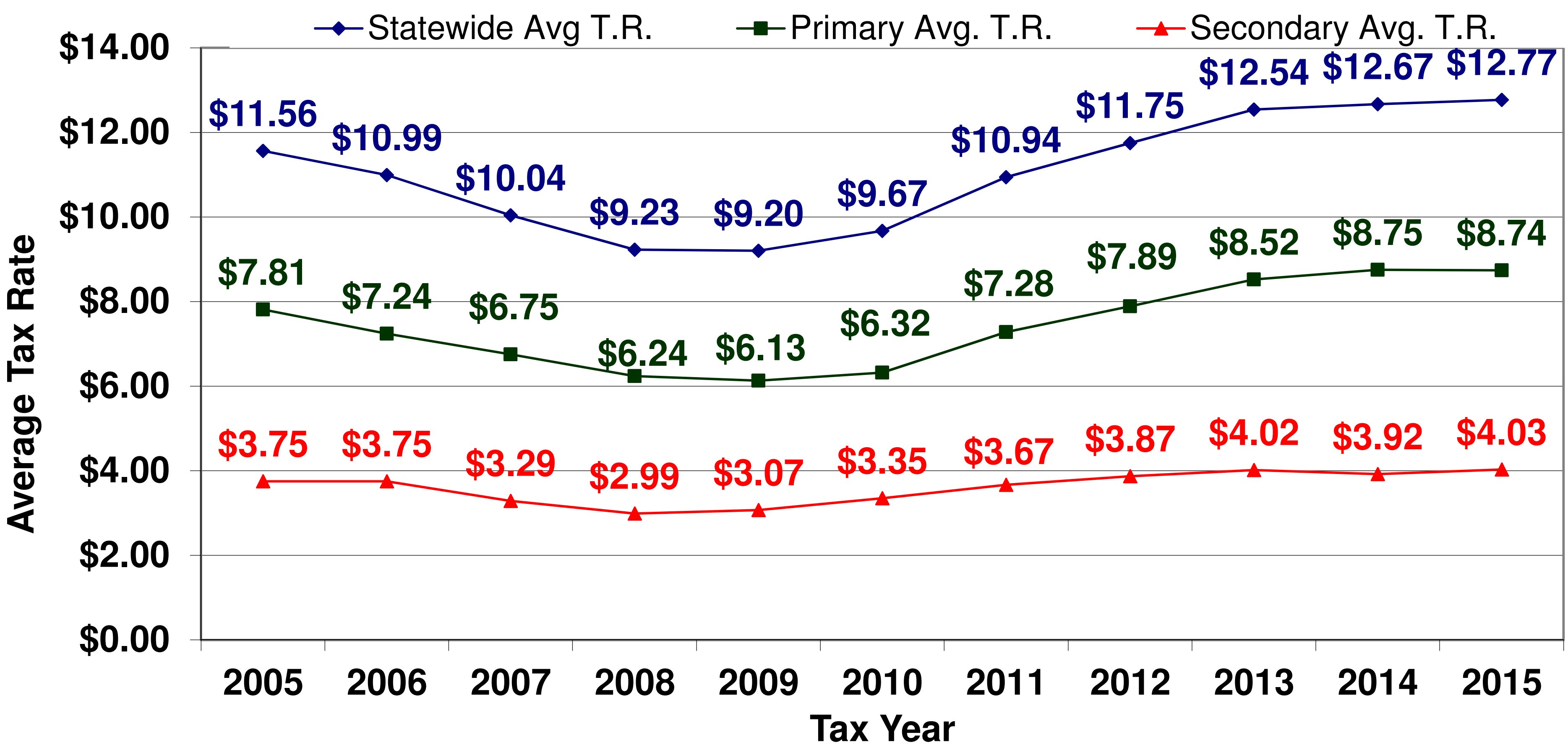


	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Primary	$3.6	$3.7	$3.9	$4.2	$4.6	$4.5	$4.4	$4.4	$4.4	$4.7	$4.8
Secondary	$1.8	$2.0	$2.4	$2.6	$2.7	$2.5	$2.3	$2.2	$2.1	$2.2	$2.2
Total	$5.4	$5.7	$6.3	$6.8	$7.2	$7.0	$6.7	$6.6	$6.6	$6.9	$7.0

10-Year Property Values

	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
FCV	$48.9	$54.4	$71.8	$86.1	$86.5	$75.6	$61.7	$56.3	$52.6	$55.4	$62.6
LPV	$46.0	$50.6	$58.3	$67.5	$74.8	$71.4	$60.9	$55.9	$52.1	$53.5	$54.8
NAV	48.9	54.4	71.8	86.1	86.5	75.6	61.7	56.3	52.6	55.4	54.8

Statewide Average Tax Rates



1% Homeowner Cap

- 1980 Constitutional reform to protect homeowners
- Total **primary** property taxes cannot exceed 1% of limited property value
  - Limited to $10 rate per $100 of assessed value
  - Includes all jurisdictions: State, K-12, City, County, Community College
- Protects no other class of property
  - Renters, ranchers, farmers, businesses, etc.
- Insulates capped homeowners from tax increases
- Incomplete version of California Prop 13
- State "picked up the tab" for 35 years (statutory)

1% Homeowner Cap

State City College County K-12

Exempt from amount in excess

$10 rate
(1%)

Homeowner

All other taxpayers have no $10 cap

Renters, Businesses, Agricultural, etc

They pay the full primary and secondary tax rate

All other

****All taxpayers pay the full secondary tax rate*

New Formula: 1% Homeowner Cap

- Ducey budget: End the unlimited state subsidy of high tax jurisdictions
- Shifted responsibility to local taxing authorities with above average tax rates; PTOC does math

One possible way to calculate new 1% Cap formula

Jurisdiction	2015 tax rate	statewide average tax rate	Overage	Shares
State (SETR)	0.5054			
Pima County	4.3877	1.97	2.42	**$8,688,024**
Pima Community College	1.3689	1.76	0.00	$0
Tucson Unified	6.5217	4.31	2.21	**$7,946,784**
City of Tucson	0.5326	0.54	0.00	$0
Totals	13.3163		4.63	$16,634,809
State liability				$943,903

Rebatable rate	1.39
NAV Class-3	$ 1,268,030,829
Total Rebate	$17,578,711
State GF payment	**$943,903
Net Rebate	**$16,634,809**

**San Fernando & Altar Valley are small 1% Cap districts, presumes they take the first draw of the $1 million from the state GF

Managing the 1% Cap

- For decades, ATRA has encouraged lawmakers to avoid changes which collide with the 1% cap

- System designed to minimize 1% Cap violations
  - School QTR follows changes in assessed value
  - Homeowner rebate intended to decrease the primary rate
  - Caps on rate growth for cities, counties & comm colleges
  - State rate is low ($.50)

- Policymakers must consider 1% cap implications in all property tax reforms

State Policy Changes Can Impact Local Property Taxes

DOR local cost sharing	$21 million
1% Cap	$20 million
Juvenile Corrections	$12 million
Sexually Violent Persons (SVP)	$3 million
Restoration to Competency	$900,000

Notable Tax Increases

Maricopa County	$ Increase	% Increase	
Primary levy	$28,430,552	6%	Increased tax rate 4 cents (6 cents over TNT)
FCD	$5,851,804	13%	Increased tax rate 2 cents

Pima County	$ Increase	% Increase	
Primary levy	$12,725,433	4%	Tax rate up 11 cents (8 over TNT)
Library	$6,520,568	20%	Tax rate up 8 cents
City of Tucson	$1,662,004	11%	Tax rate up 5 cents (5 cents over TNT)

Pinal County	$ Increase	% Increase	
Primary levy	$6,106,052	8%	Tax rate up 20 cents (22 cents over TNT)
Community College	$9,019,179	24%	Tax rate up 39 cents (40 cents over TNT)

Yuma County	$ Increase	% Increase	
Primary levy	$2,998,262	12%	Increased tax rate 25 cents (19 cents over TNT)
Community College	$2,002,035	9%	Tax rate up 16 cents (11 cents over TNT)
City of Yuma	$1,190,230	12%	Tax rate up 24 cents (19 cents over TNT)

Gila County	$ Increase	% Increase	
Primary levy	$2,782,807	16%	Maintained same tax rate/NAV up 16% (37 cents over TNT)

K-12 and the 1% Cap

- Post 1980 wrinkles exacerbate 1% cap problems
  - Desegregation/Office of Civil Rights levy
    - TUSD has rate 150% above average
    - Phx Union + OCR Elementary = 5 capped districts

      Phoenix Elem. Isaac Elem. Cartwright Elem.

      Roosevelt Elem. Wilson Elem.
  - Adjacent Ways, Transpo Delta
- Small School Adjustment – responsible for many 1% cap areas
- Cash balance correction
  - School district under levied in previous year; has negative cash balance
  - Must spike rate to correct = pushes them over 1% cap
  - Example: Isaac Elementary, Tombstone Unified
- Result: State GF pays for (or subsidizes) non-formula programs

1% Cap Districts

- Pima County
  - Tucson Unified
  - San Fernando Elementary
  - Altar Valley Elementary
- Pinal County
  - Maricopa Unified
  - Superior Unified
  - Florence Unified
  - Casa Grande El/Union
  - Mammoth/San Manuel Unified
  - Eloy El/Santa Cruz Valley Union
  - Coolidge Unified
  - Toltec El/Casa Grande Union
  - Combs Unified
- Maricopa Unified
  - Roosevelt El/Phx Union
  - Phoenix El/Phx Union
  - Isaac El/Phx Union
  - Wilson El/Phx Union
  - Cartwright El/Phx Union
  - Mobile El
  - Morristown El
  - Sentinel El
- Several others, amounts not exceeding $1 million/county
  - Cochise close at $960k
  - State GF liability ~$4.4m
  - Local liability ~$26m
  - 38 total school districts

Taxpayers Needed that Trailer Bill

- ATRA predicted new formula would simply raise tax rates
  - Tax rate increases from several 1% cap liable jurisdictions
    - Pima County
    - Pinal County
    - Pinal County Community College District (Central AZ College)
    - Town of Superior
  - Homeowners insulated from increases again
  - As rates raise, liability for 1% cap raises
  - Property taxpayers put in death spiral

- Fix bill necessary
  - 1% cap fix shouldn't expose non-class 3 properties to even higher taxes
  - Precedent: Maximum school tax rate law for high rates in 1% cap areas
- Other technical issues
  - How to calculate state average?
  - Math to determine "at fault" percentages
  - How to protect non-Class 3 property?
  - How to parcel out the $1 million per county GF liability?

Questions?

1814 W. Washington Street
Phoenix, Arizona 85007
(602) 253-9121

www.arizonatax.org
atra@arizonatax.org

The taxpayer's watchdog for 75 years

Property Tax- Deseg/OCR

- Phase out Deseg/Office of Civil Rights levies
  - Funded exclusively by local property tax- $211m/year
  - $4 billion went to just 19 districts over last 30 years
  - No planned phase out
- 10 year phase out for districts with court order
  - Hold Tucson Unified harmless until declared unitary
- 5 year phase out for districts with OCR agreement
  - Districts never had court order to desegregate
  - No federal requirement for spending
  - Most no longer being monitored for issue by OCR
- Fixes biggest loophole in K-12 finance
  - Pre-requisite for school finance overhaul
  - Provides significant property tax relief in those districts

Property Tax- K-12 primary rate reform

- "Districts keep their cash, taxpayers keep their rate"
- School districts long complained their cash "counts against them"
  - Charters can carryforward any amount of cash
  - Districts limited to 4% carryforward capacity
  - Any leftover cash beyond that creates a reduction in the primary tax rate
- Every June 30, superintendents certify their cash balance to county
  - Notoriously bad data; based on many assumptions
  - Counties rely on school district info
  - Bottom line: school districts control their primary tax rate
- When school districts tax too little, tax rate spikes in future
  - Budget authorization allows districts to spend into debt without cash
- ATRA proposes to end the primary rate chaos
  - Let districts manage cash as they see fit; remove 4% carryforward limit
  - Stop the games with primary rate ie. levying too little during election years
  - Levy the QTR each year or amount to fund district support level for non-state aid
  - Submit primary levy worksheet to county supt outlining non-formula levies
- Not a tax hike; stabilizes tax rates; more flexibility for schools

Sales Tax

- 2013 TPT reform implementation stalled
- Provision requires DOR capture data with sufficient specificity to meet needs of cities
- Result: cities have ‘GO’ lever on TPT reform
- ATRA will seek repeal of requirement

Comm Colleges Expend Limit

- Expenditure Limit study committee revealed:
  - Committee found problems with FTSE estimates
  - Districts financial concerns
- ATRA will propose
  - FTSE estimate based on an easy formula
    - "Soft landings" for contracting districts
    - Growth option for those growing
  - Adding override option for districts
  - Exclude entrepreneurial, non-credit $ from E.L.
- ATRA will oppose
  - Efforts to complicate how a FTSE is counted
  - Efforts to "blow-out" the expenditure limit

Threats to Taxpayers

- Tax Increment Financing
- Fire District property tax rate expansion

Property Tax- Adjacent Ways

- Key problem area in K-12 finance: $60-$100m/yr
  - Funded by local property tax; drives inequitable tax rates
  - Statutorily limited to public rights of way
    - Sidewalks, gutters, deceleration lanes, etc
- Add oversight for Adjacent Ways levy
  - Presently only requires Governing Board vote/TNT hearing
  - Districts often levy before project identified
  - Levy used by districts to "manage their tax rate"
- Create accountability for use of funds
  - Levy historically abused
  - Recent fraud: Higley illegally used $6.4 million for lease payments
- Require School Facilities Board validate
  - Project statutorily qualifies as Adjacent Ways
  - Bid is for the Adjacent Ways project
  - Then school district can proceed with levy