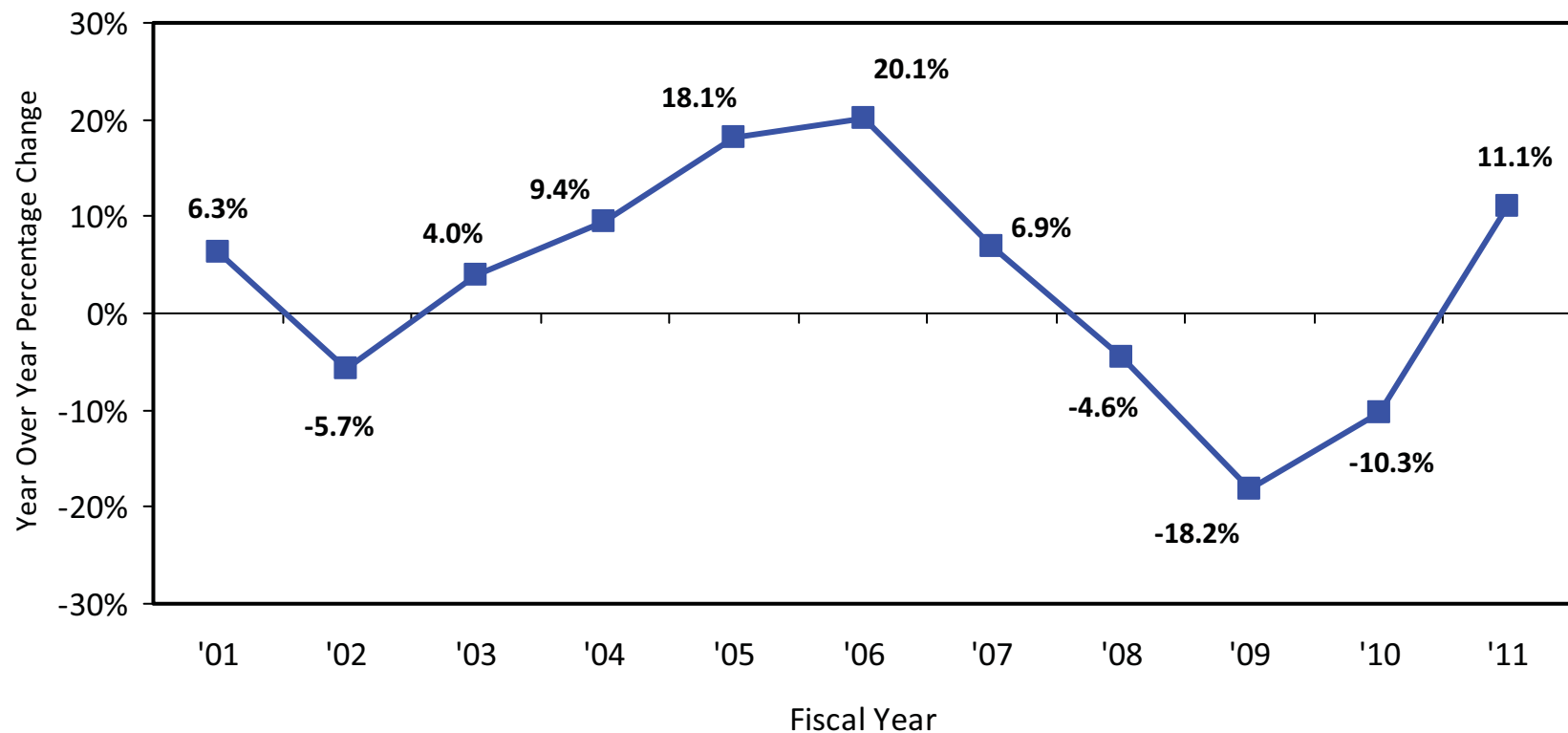

Presentation to the Greater Phoenix Chamber of Commerce

December 12, 2011

JLBC

FY '11 Base Revenues Post Gain After Unprecedented 3-Year Decline



Percent Change in Base Revenues Excluding Urban Revenue Sharing, statutory and one-time changes.



The FY '11 Recovery Is a Reflection of 1-Time Factors

- ❑ FY '10 was the bottom of the recession when revenues fell below FY '04 level – easier to post gains off such a low base
- ❑ Corporate profitability rose considerably – more due to higher productivity than higher revenues
- ❑ Individual income increase is more likely a function of capital gains and a loss of mortgage deductions than of significant job and wage growth

FY 2012 1st Quarter Growth Rate 7.1%

- \$126 M Above Forecast

	% Change over 1 st Qtr. FY '11
Sales Tax (without 1-cent)	7.2%
Individual Income Tax	9.8%
Corporate Income Tax	10.9%

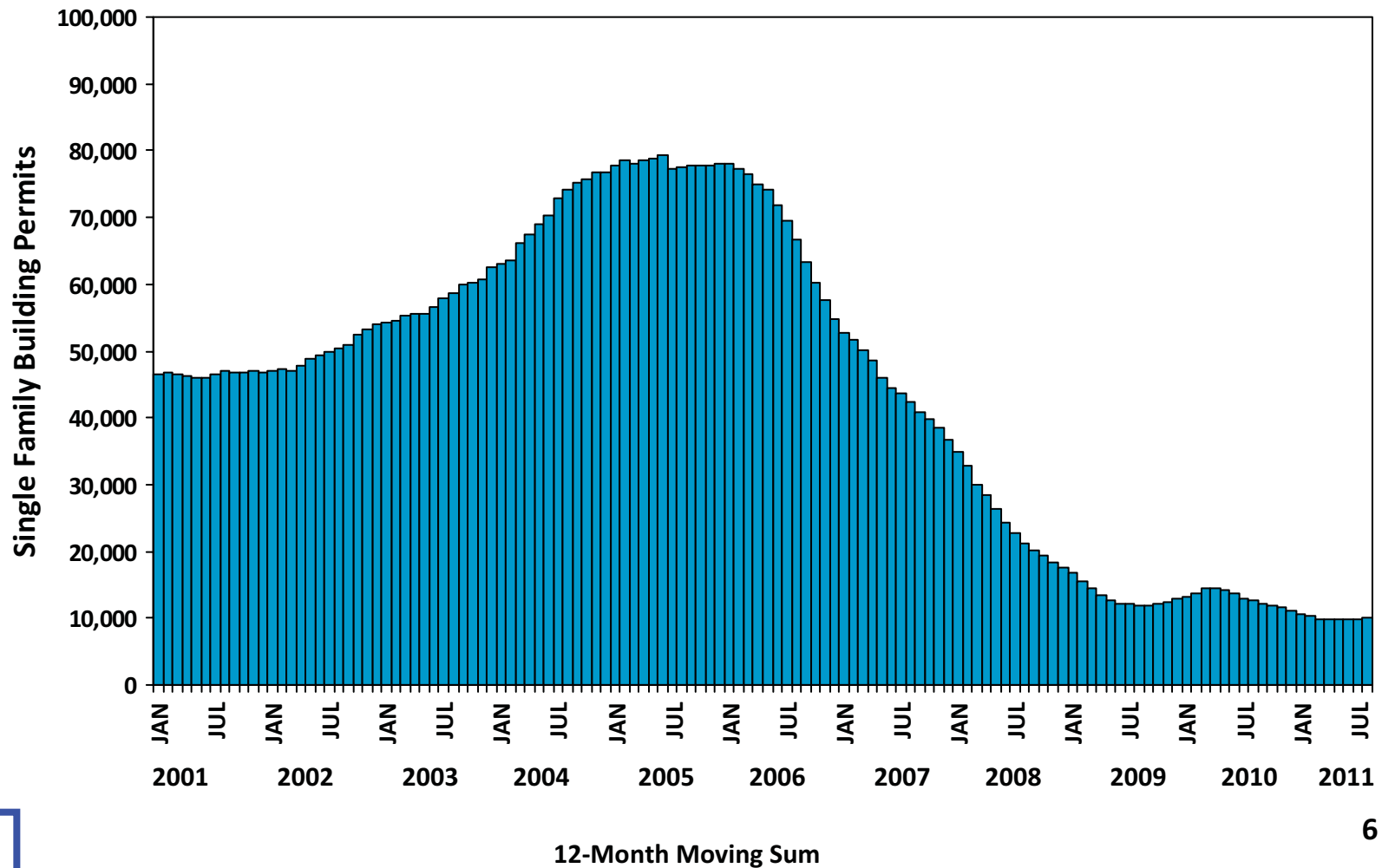
- ❑ Strong sales performance partially due to negative 1st quarter in FY '11
- ❑ Healthy growth rate in April income tax collections resulted in higher estimated payments for the rest of calendar 2011

The Road to Recovery Will Still Be Long

- Decline in Pending Foreclosures Is One Positive Sign

	Highpoint	Now
Jobs Lost Since December 2007	398,800 (July 2010)	301,800
Pending Maricopa Foreclosures	51,500 (Dec. 2010)	22,901
Mortgages Underwater	51.3% (Q4, 2009)	48.7% (Q2, 2011)

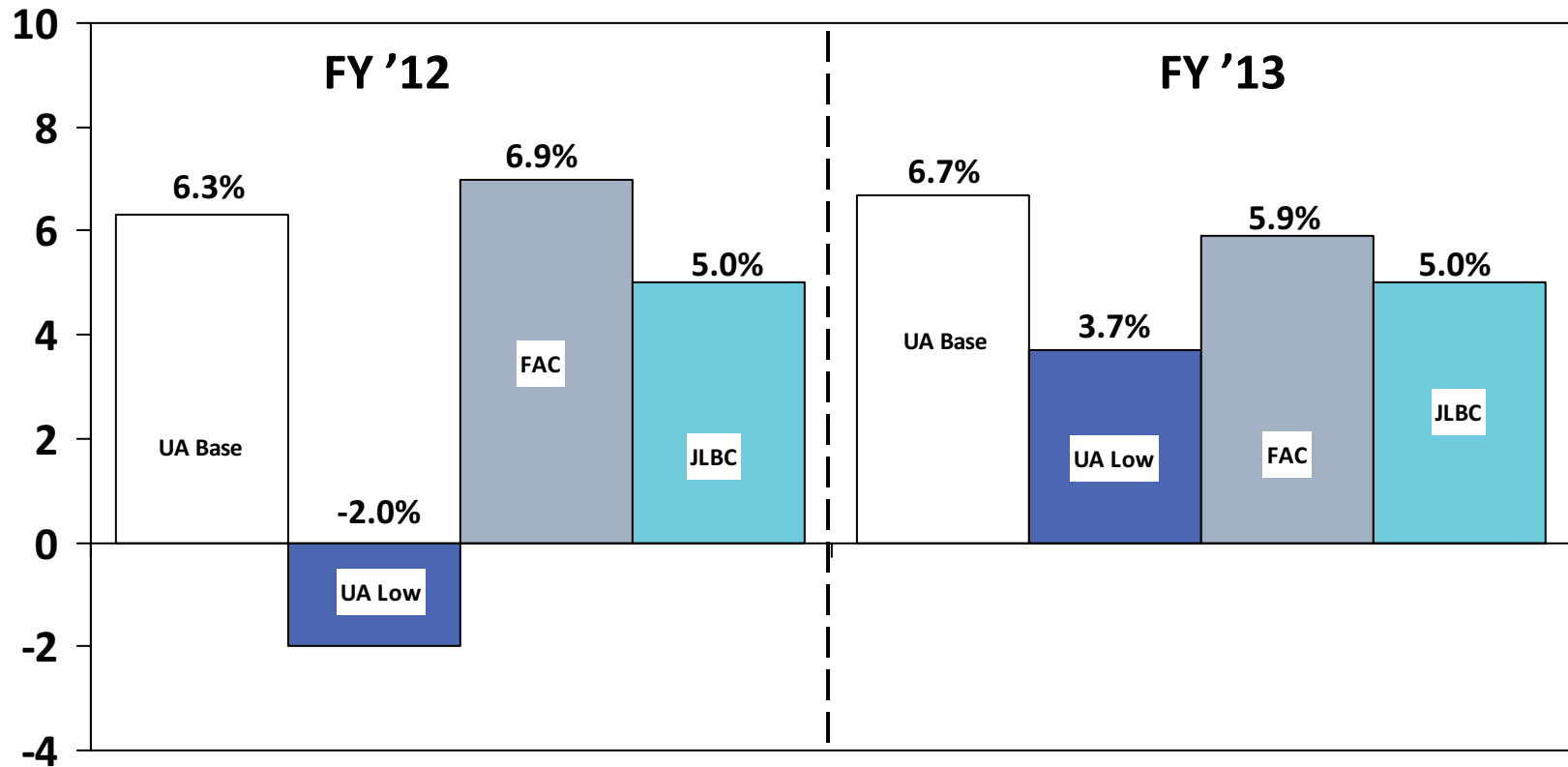
Single Family Permits Suggest Construction Recovery Not Imminent



Forecasting Constraints In the Next 3 Years

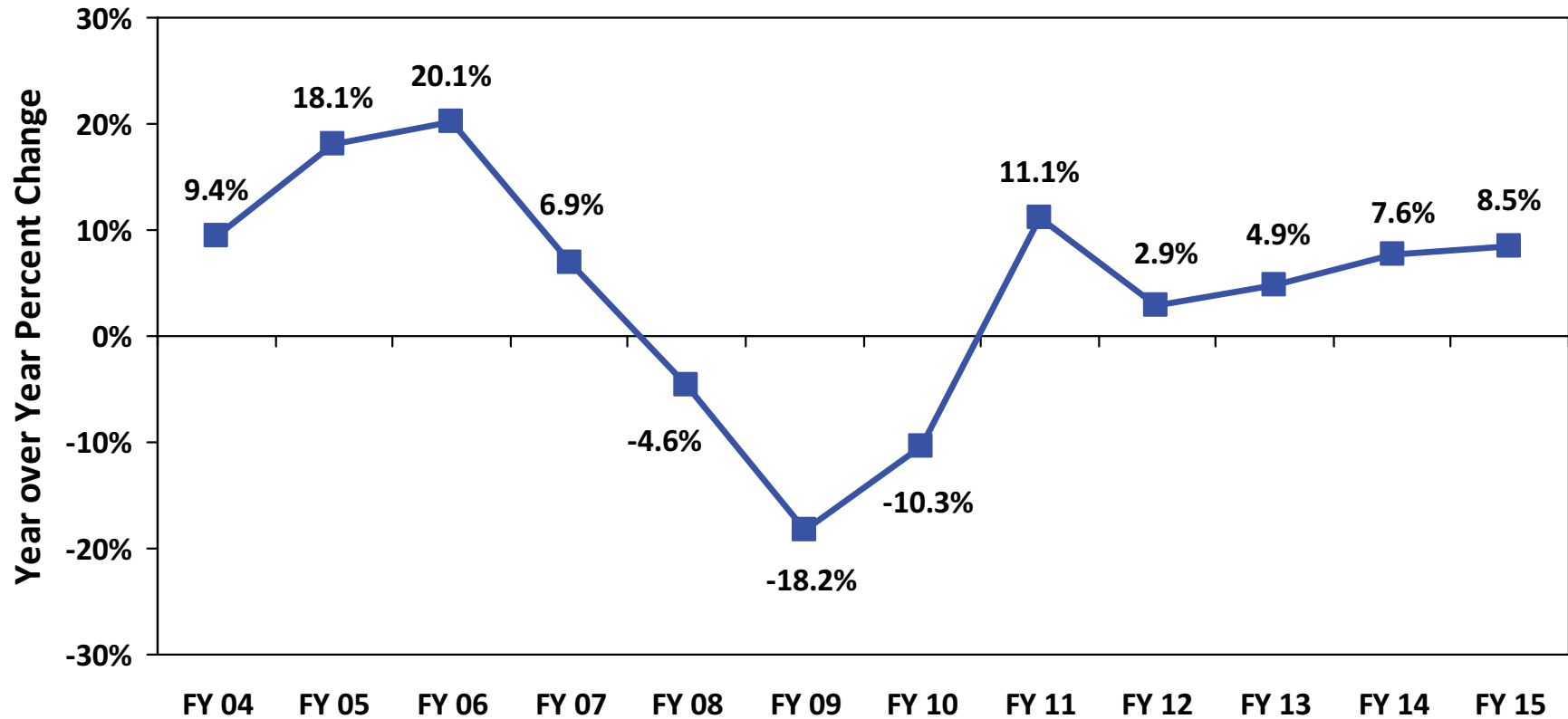
- ❑ While revenue recovery has begun, it is difficult to forecast its speed
- ❑ Current forecasts are most useful in determining the direction of the economy, not its precise landing point
- ❑ Certain structural factors limit potential for rapid growth
- ❑ Small forecast errors can have a large impact -- 1% error in the revenue growth rate over 3 years can change revenue collections by \$500 million

Consensus Predicts Base Growth Rate of 2.9% in FY '12 and 4.9% in FY '13*



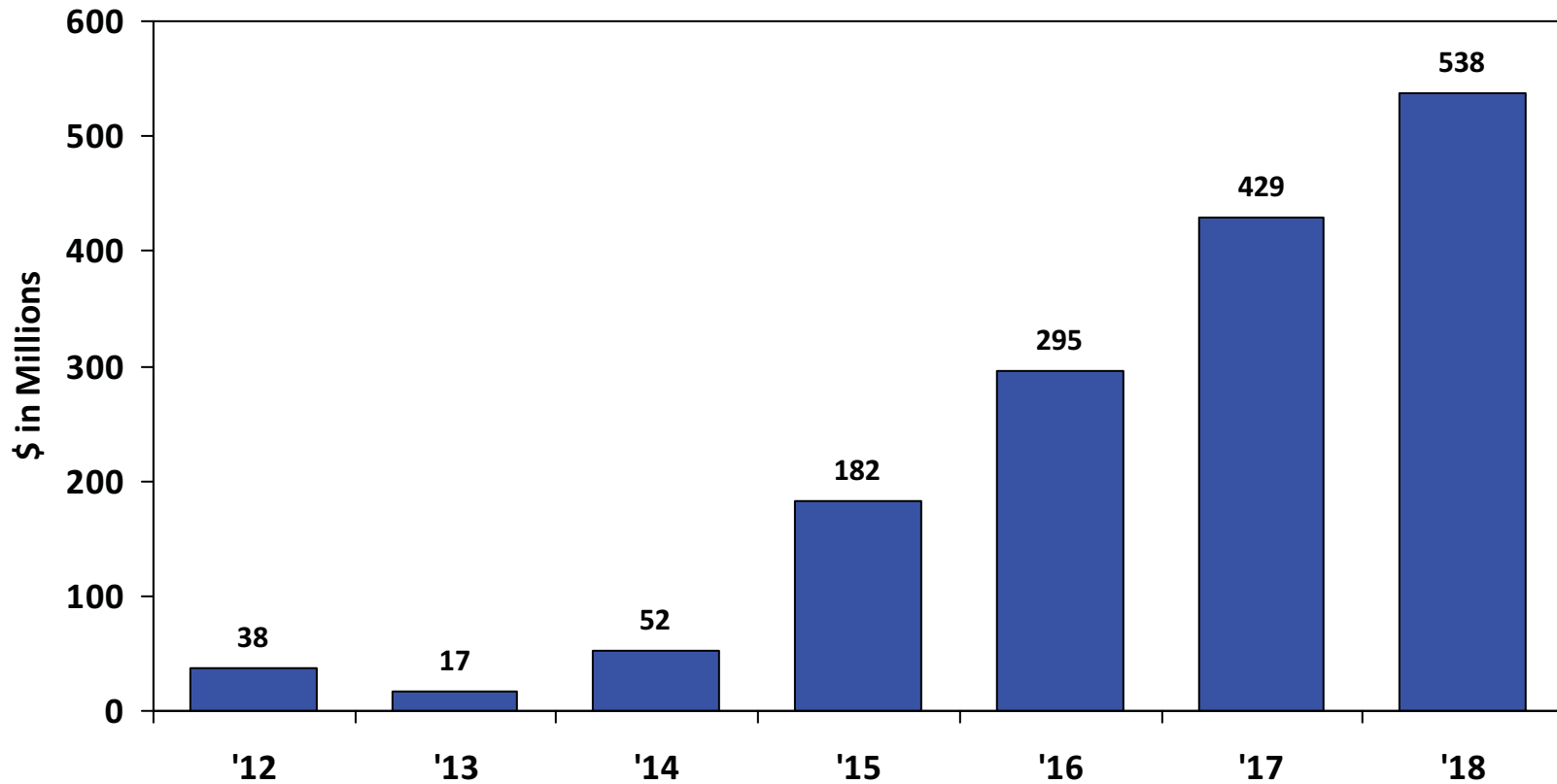
* Weighted Big 3 average growth prior to 1-Cent sales tax is 4.0% in FY '12 and 5.4% in FY '13. After adjusting for small tax categories, the base growth rate is 2.9% in FY '12 and 4.9% in FY '13.

Consensus Forecasts Steadily Rising Revenue Growth Rate Through FY '15



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

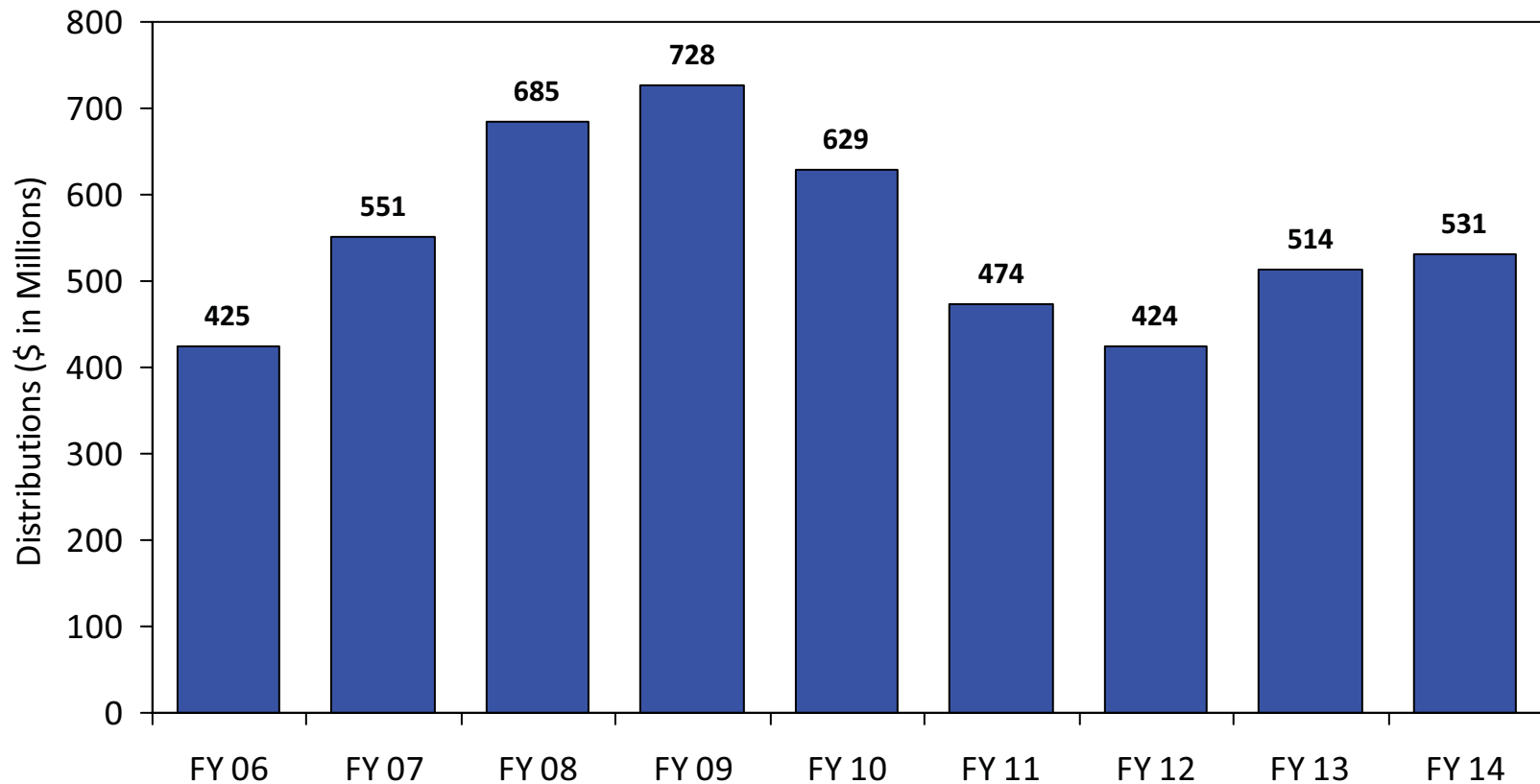
Enacted AZ Jobs Bill Will Not Have Major Fiscal Impacts Until FY 2015



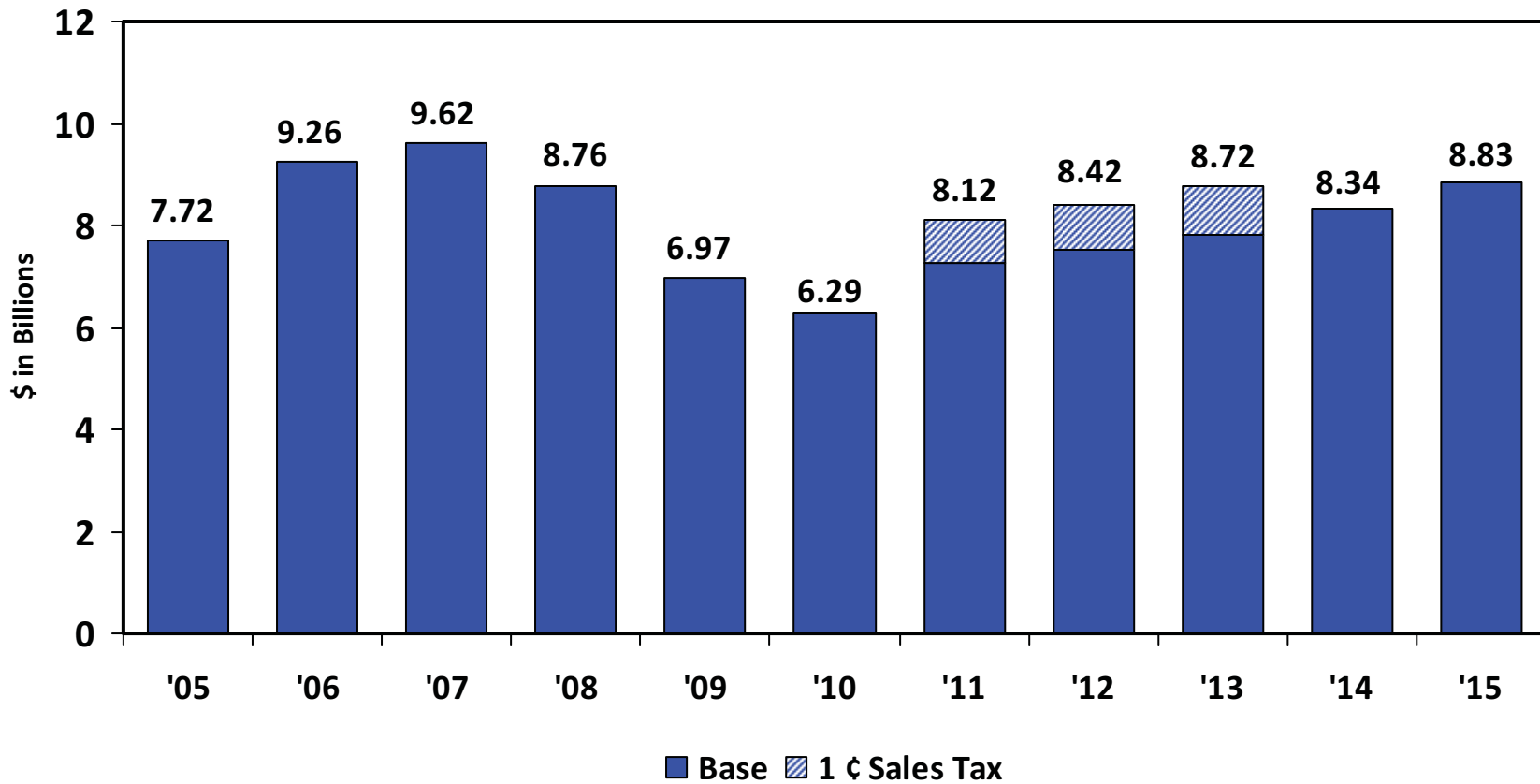
Revenue Loss/Spending Increase Relative to Original FY 2012 Baseline Forecast

Income Tax Revenues Determine Urban Revenue Sharing

– Amount Linked to Income Tax Collections 2 Years Prior



Consensus Forecasts Still Below FY '07 Level



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

Consensus Forecast Poses Some Major Risks From A Budget Standpoint

- ❑ In short term, Consensus may not give adequate weight to recession scenario
 - Leading national forecasters place recession risk at 40% to 50%
- ❑ In the long term, Consensus assumes very strong growth in FY '14 and FY '15
 - Difficult to predict 3 years in advance and may result in false sense of optimism
- ❑ To address these concerns, the Baseline revenue projections have been modified
 - Add second “slow economy” scenario at rates 2% below Consensus
 - Consensus revenue growth rates for budgeting capped at 7% -- the prior long-term average

Spending Issues Further Cloud Overall Budget Picture

- ❑ The State is subject to numerous “budget” lawsuits – such as freeze in Medicaid childless adult coverage and the K-12 inflator
- ❑ Federal budget negotiations may lead to reduction in State aid
- ❑ IRS requires State to use operating surplus above 5% (\$400 M) to pay off “operating” issuances early
 - Represents a requirement of the State using tax-exempt financing for the \$1.5 B state building sale/leaseback and lottery revenue bonds
 - Calculation is complex and final requirement is not known until ADOA releases an annual report six months after end of fiscal year
 - Preliminary estimate of this requirement in FY '12 is \$72 M

Given Revenue and Spending Risks, There Are 2 Baseline Budget Scenarios

- ❑ Scenario 1
 - Consensus revenue estimates
 - Active formula Baseline spending estimates
- ❑ Scenario 2
 - Substitutes “slow economy” revenue estimates
 - Same active formula spending, but adds \$200 M if plaintiffs successful in budget lawsuits
- ❑ The 2 scenarios do not represent a lower and upper bound. Outside factors like the federal government could influence future budget projections.

FY '12 – '14 Budget Projections

Scenario 1	<u>12</u>	<u>13</u>	<u>14</u>
Revenues	\$8.8 B	\$8.7 B	\$8.3 B
Spending	\$8.4 B	\$8.5 B	\$8.9 B
Balance	\$416 M	\$143 M	\$(610) M

Scenario 2	<u>12</u>	<u>13</u>	<u>14</u>
Revenues	\$8.7 B	\$8.3 B	\$7.8 B
Spending	\$8.5 B	\$8.7 B	\$9.1 B
Balance	\$133 M	\$(375) M	\$(1.2) B

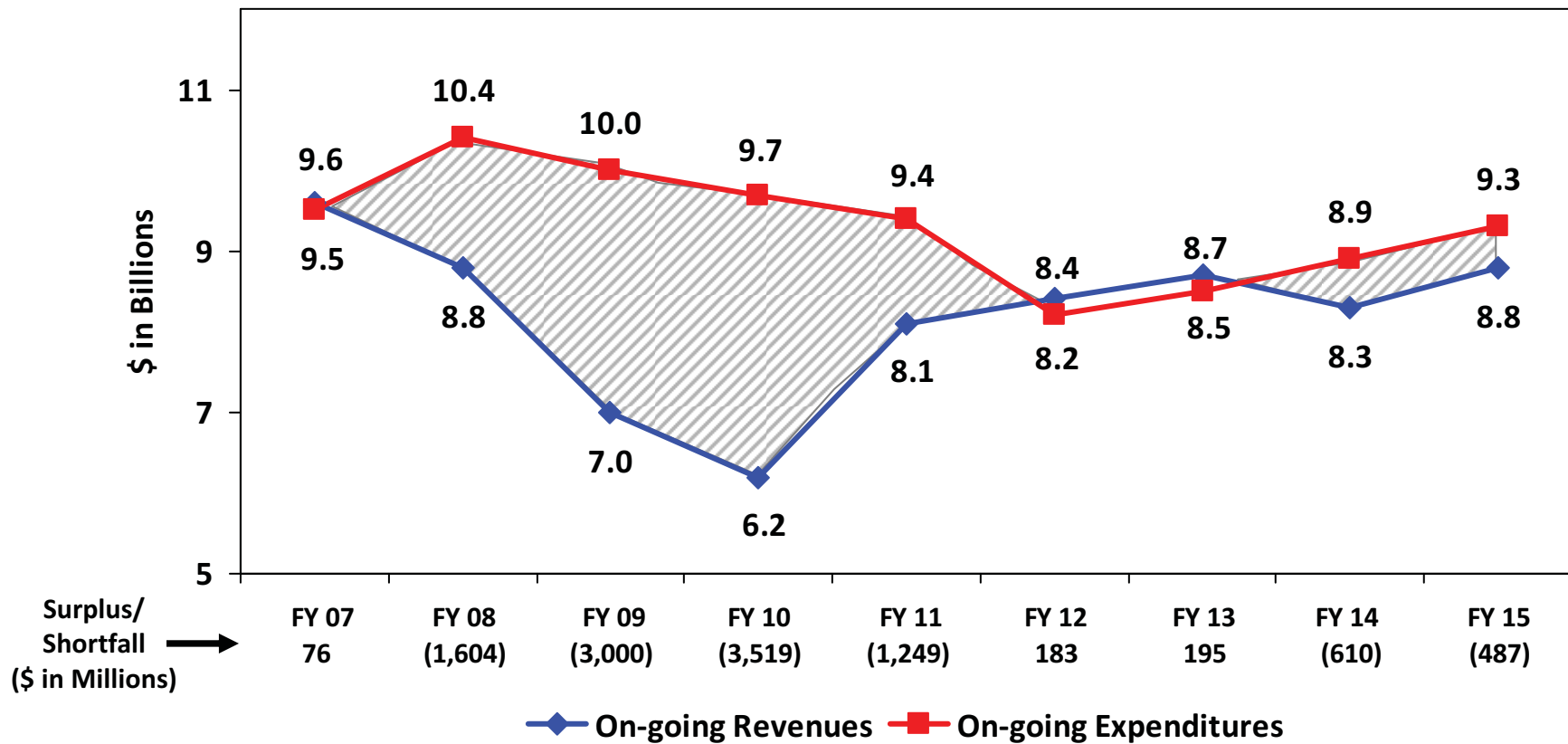
FY '12 Carryforward Balance Is One-Time

- ❑ Due to the expiration of the 1-cent sales tax at the end of FY '13, budget is unbalanced in FY '14
- ❑ Any use of short-term carryforward for new permanent revenue or spending changes in FY '12 or FY '13 would further increase future shortfalls
- ❑ But difficult to know magnitude of the carryforward until much later in the fiscal year

Under Scenario 1, Shortfall Re-emerges With Expiration of 1-Cent Sales Tax

- Consensus Revenues and Baseline Spending

“The Structural Balance”

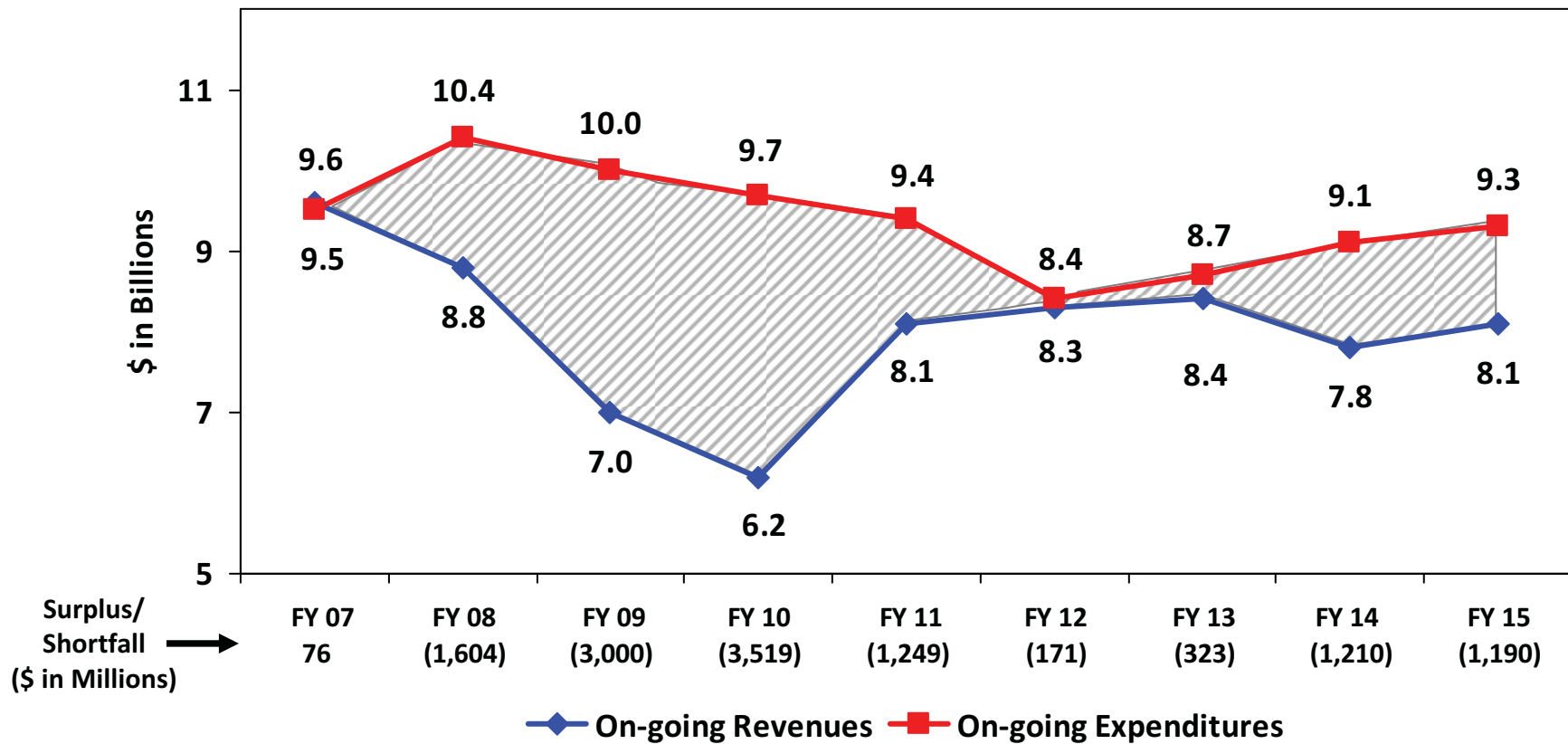


Counts 1 ¢ TPT as on-going in FY '11 – FY '13



Under Scenario 2, FY '14 Shortfall Grows to \$(1.2) B - Slow Economy and Plaintiff Litigation Verdicts

“The Structural Balance”



Counts 1 & TPT as on-going in FY '11 – FY '13



Summary of the Budget Outlook

- ❑ Since FY '11 shortfall no longer has to be paid off with FY '12 revenues, state will likely generate a carryforward balance at the end of FY '12
- ❑ Projected FY '12 carryforward balance is \$130 M or \$415 M under 2 scenarios - but estimates are not reliable at this time due to economic uncertainty and pending litigation.
- ❑ Using FY '12 balance for any new permanent revenue decrease or spending increase would increase future year shortfalls.
- ❑ It is unclear whether the FY '13 budget will be in balance or have a projected shortfall. With expiration of 1 cent sales tax, however, we would incur a FY '14 shortfall of \$600 M (Scenario 1) or \$1.2 B (Scenario 2).
- ❑ 3 Year estimates are highly speculative - small changes in growth rates could result in a balanced budget in FY '14 or a \$(1.7) B shortfall.