Finance Advisory Committee

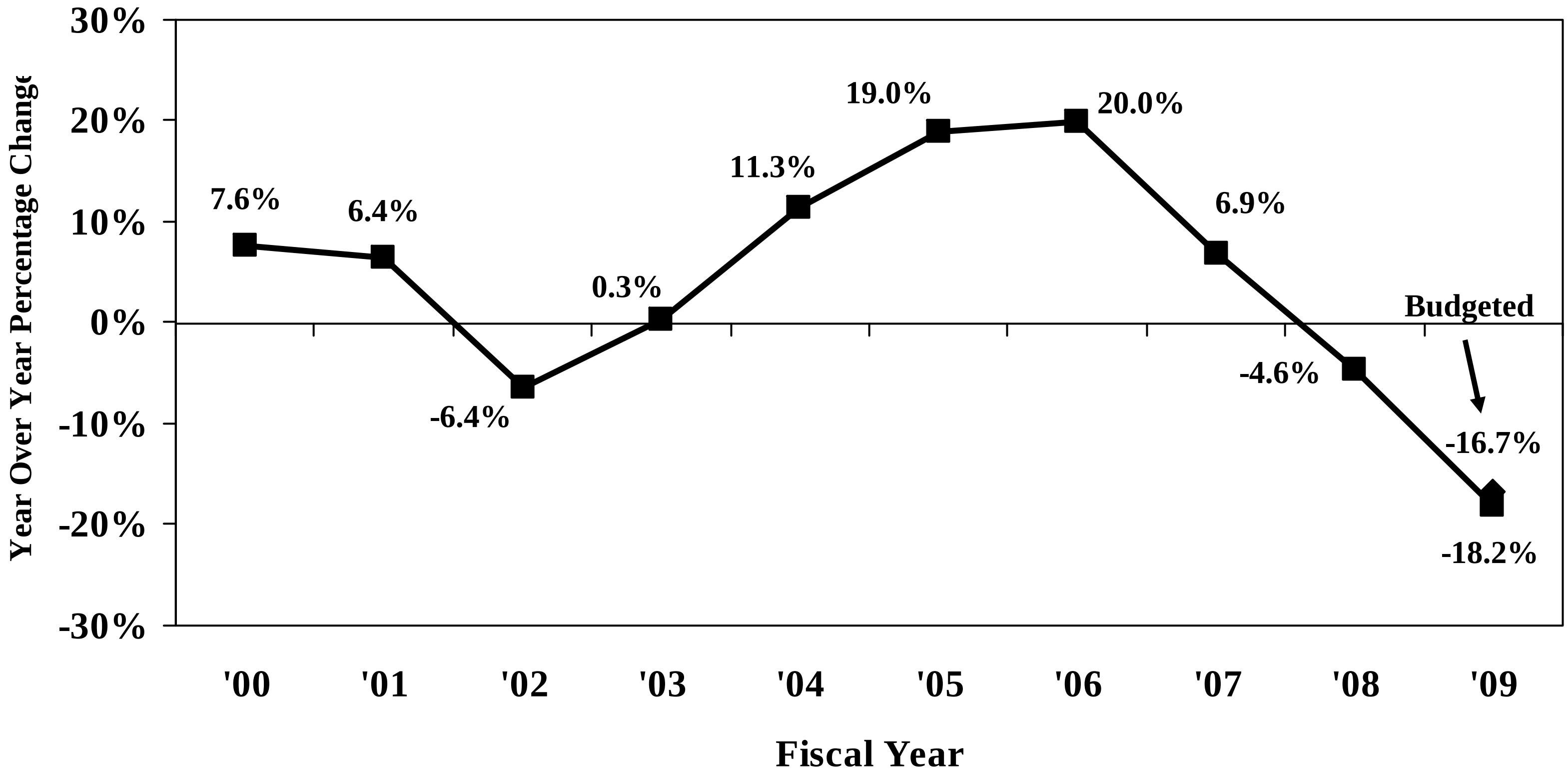
Revenue and Budget Update

October 22, 2009

JLBC

’09 General Fund Base Revenue Decline of (18.2)% Was Greater Than Budgeted

- Represents Worst Two Year Loss in Modern Era



Excludes statutory and one-time changes.

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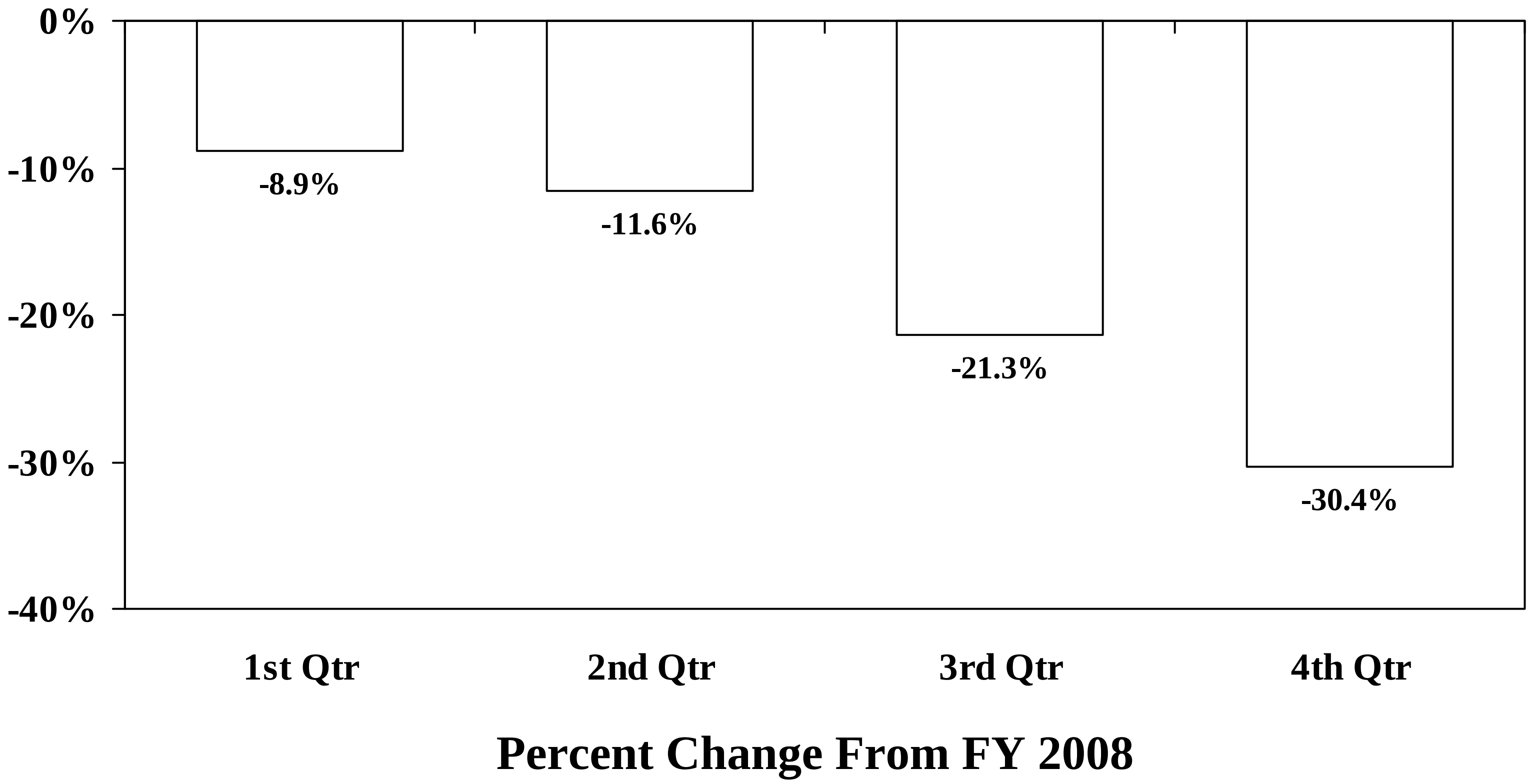
Decline Accelerated Throughout FY ’09

- Given This Pattern, Can Expect Higher % Losses in 1st Half of FY ‘10



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FY '10 Revenues Will Need to Grow By 0.9% to Meet $7.1 B Budgeted Level

• Enacted budget FY '10 growth compared to enacted '09 Budget	(0.9)%
• Growth adjusted for lower '09 Base	0.9%

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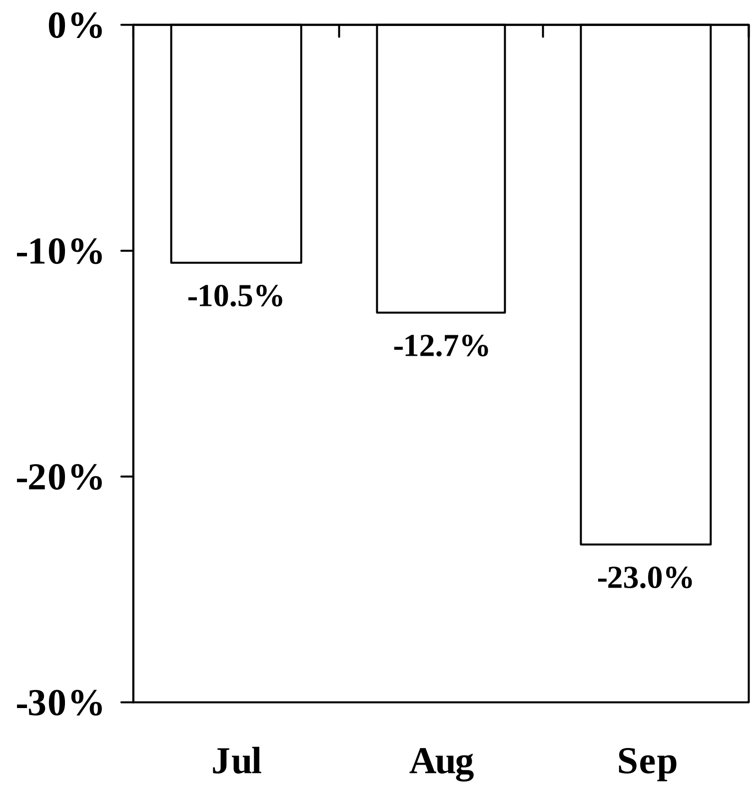
’10 Revenue Collections Continuing to Decline

- 1st Quarter Decline = (16.1)%

- 1st quarter revenue shortfall = $(233) M
- September decline due primarily to low quarterly income tax collections



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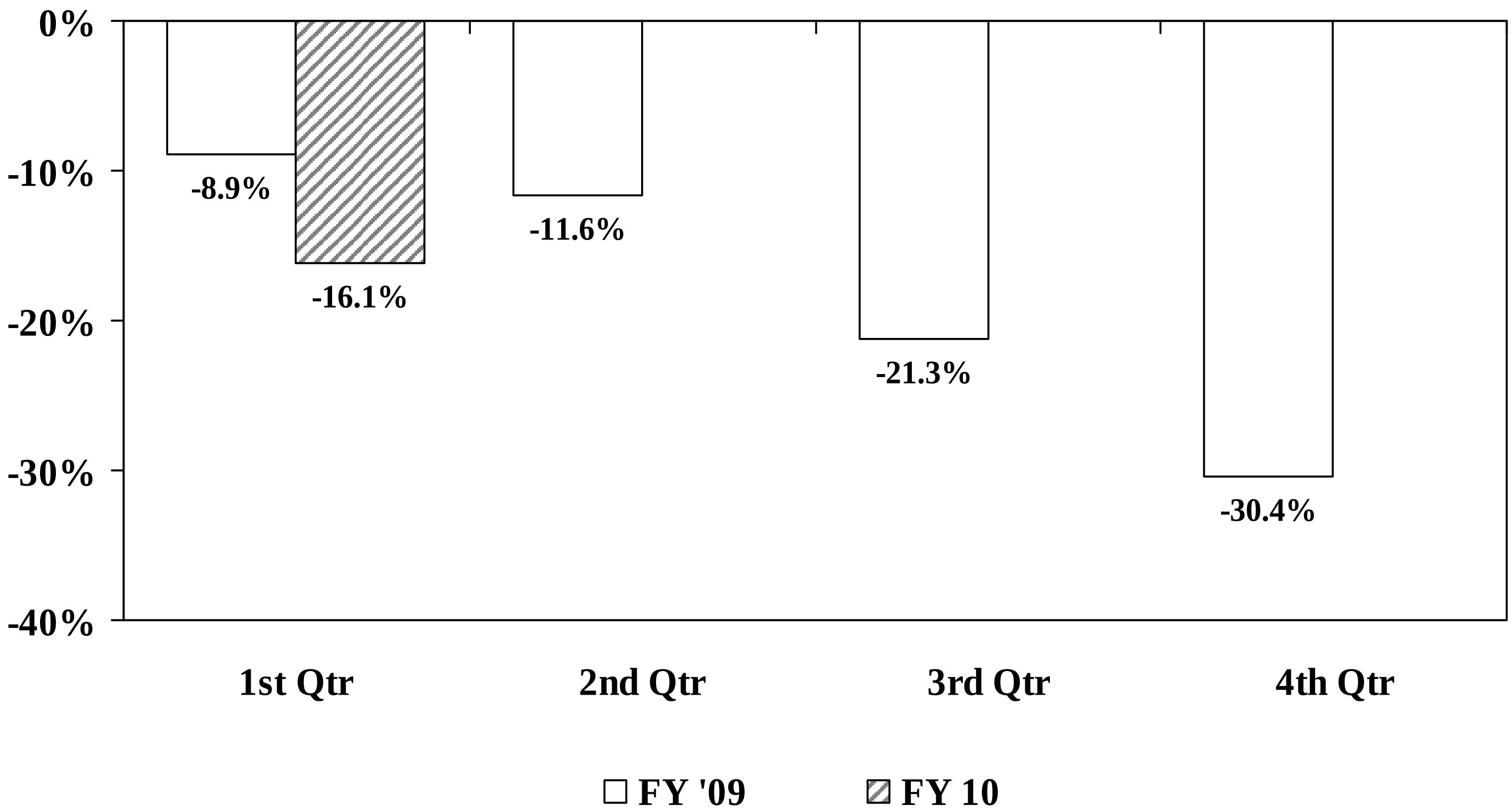
(16)% 1st Quarter Decline is Relative to a "Higher" Base

- % Decline Unlikely to be Replicated for Full Year



Percent Change From Prior Year

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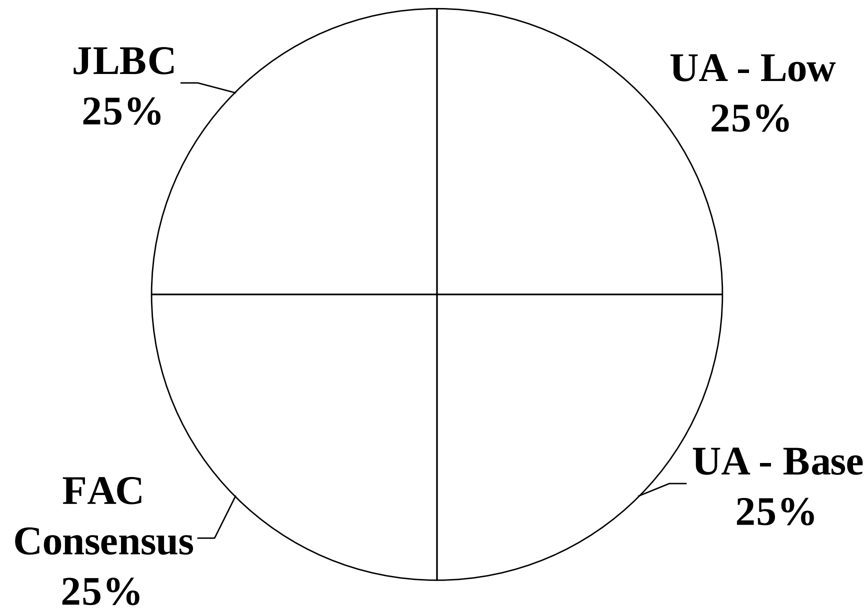
Where Are We Headed Over the Next Few Years?

- 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
- Remaining revenues (10% of total) are staff forecast



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

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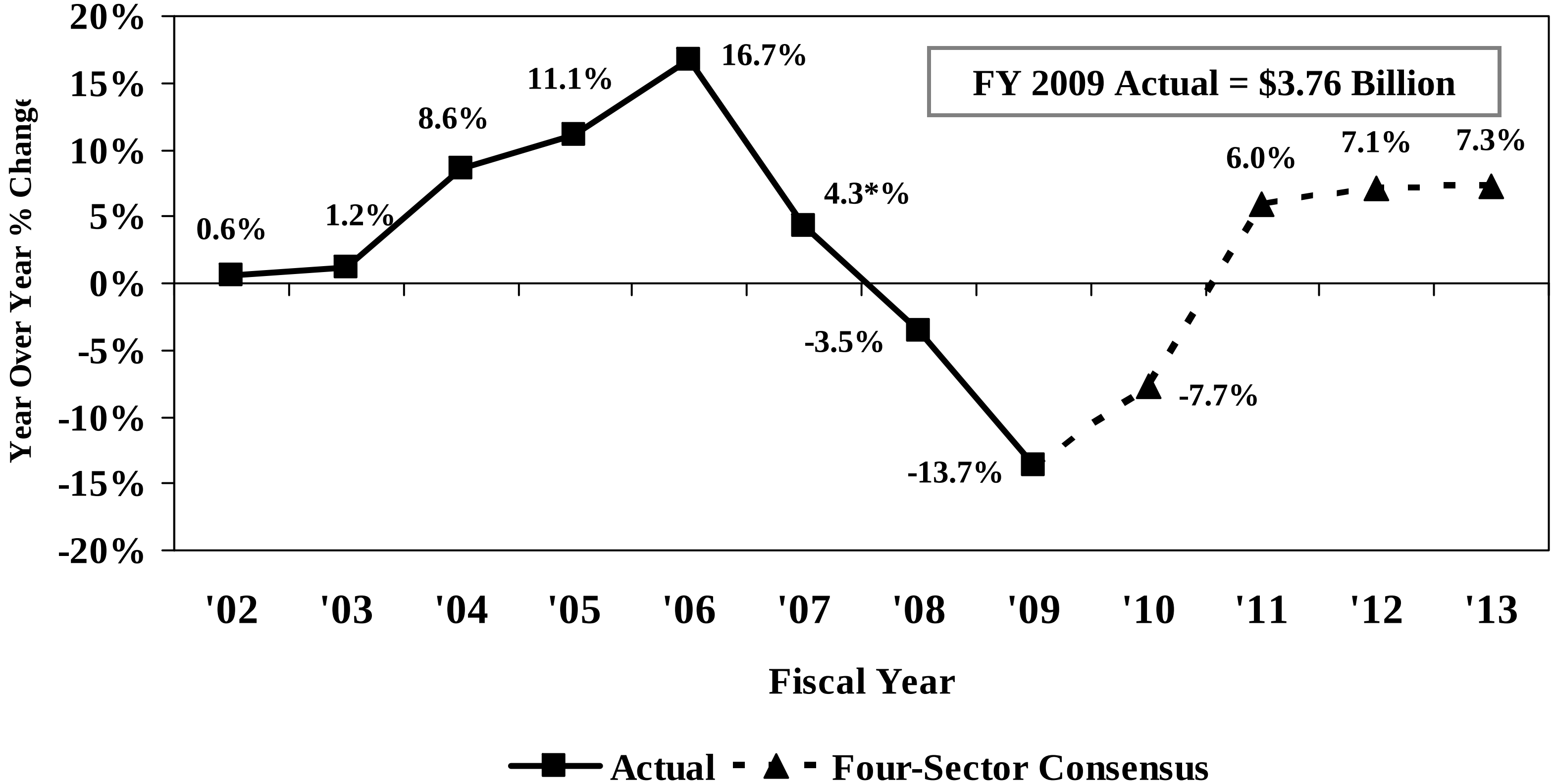
Consensus Forecasts 7.8% Growth in FY '11

- What Would Cause the Turnaround?

- National economic recovery is expected to pull the Arizona economy along
- Retail sales will increase as a result of some pent-up demand built up during the downturn
- Starting point of the recovery is so low in dollar terms that it may be relatively easy to generate positive growth

Sales Tax

- The Consensus Forecasts Decline of (7.7)% in FY '10, with Positive Growth Rates Beginning in FY '11



* 5.6% without the $(55.2) million estimated payment threshold change.

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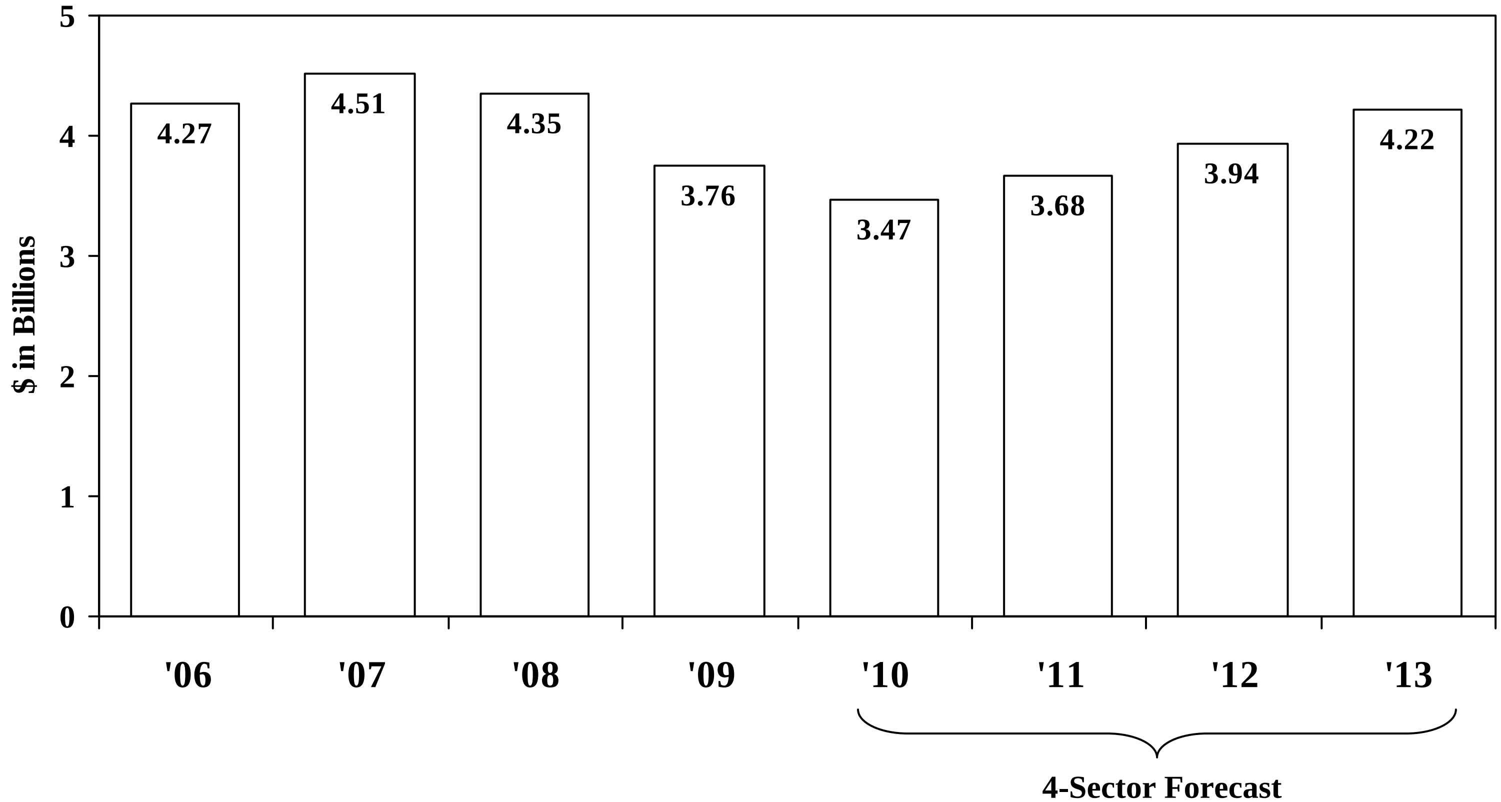
Sales Tax

- Despite 6% - 7% Growth, Collections Would Not Reach FY '06 Level Until FY '13



Includes enacted tax law changes.

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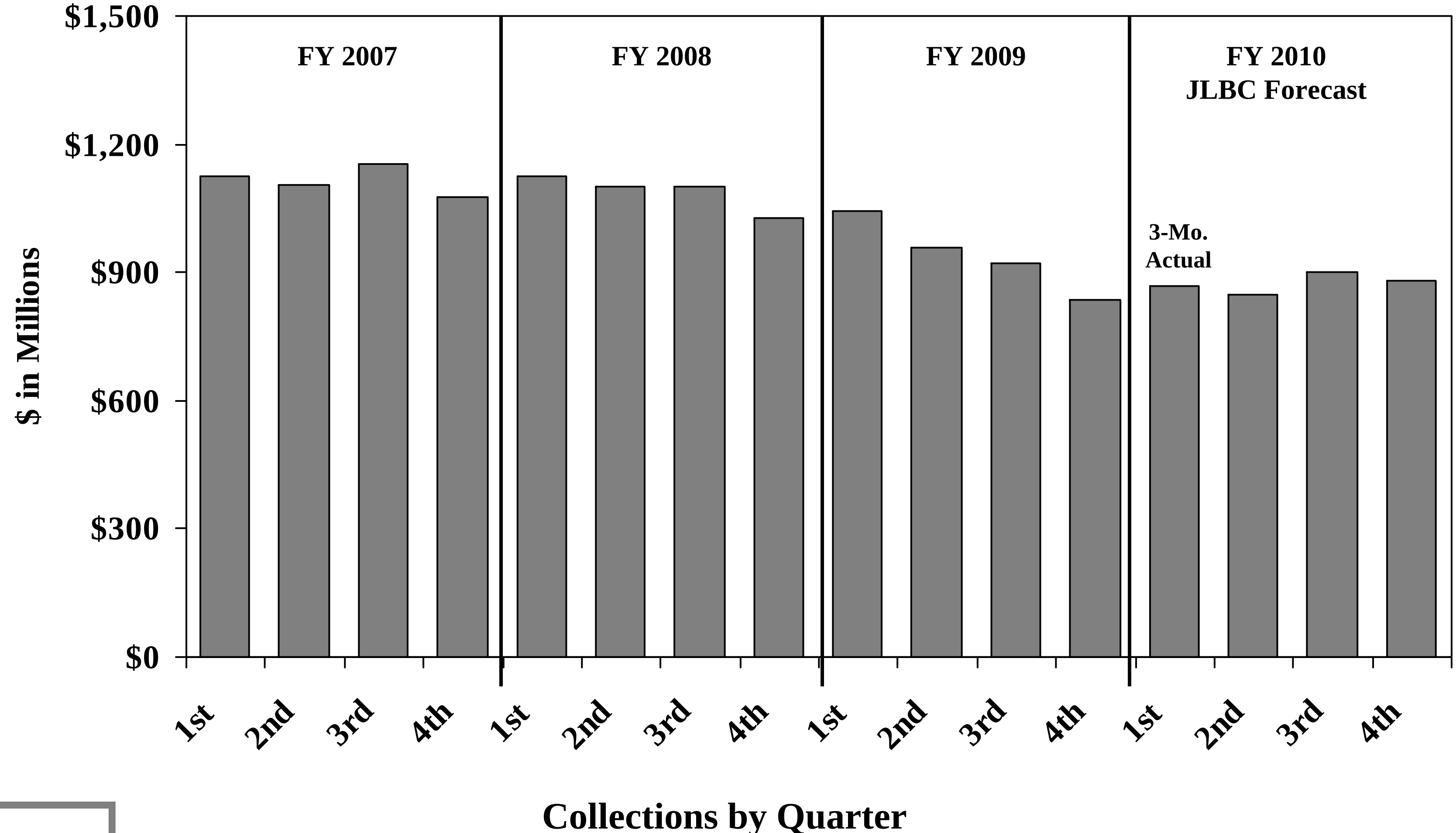
Sales Tax Collections Appear to Have Stabilized

- Second-Half Flat Growth Still Leads to Yearly Decline



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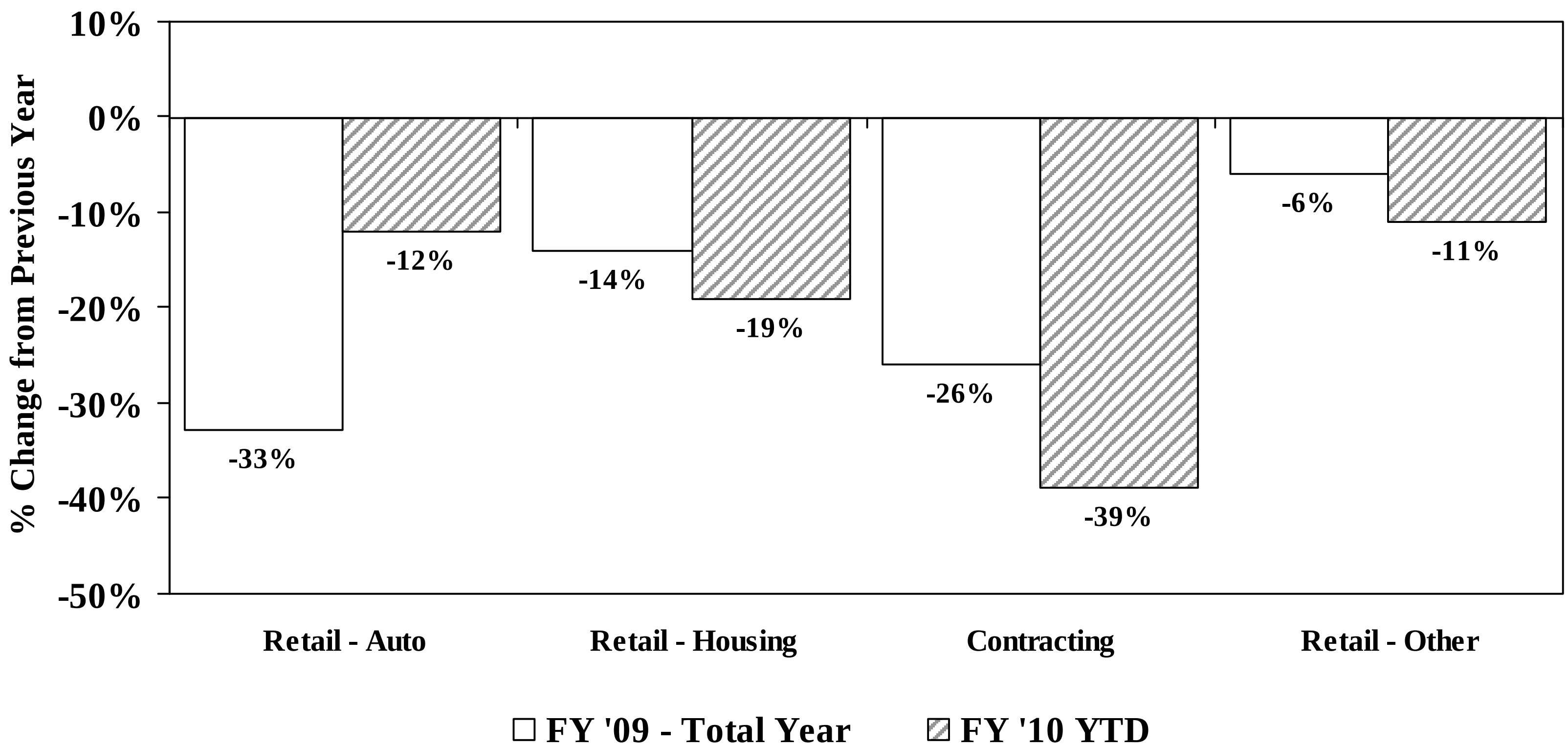
Building and Vehicle Spending Represent 30% of Sales

- In 1st Quarter, Vehicles "Improved" and Contracting Declined



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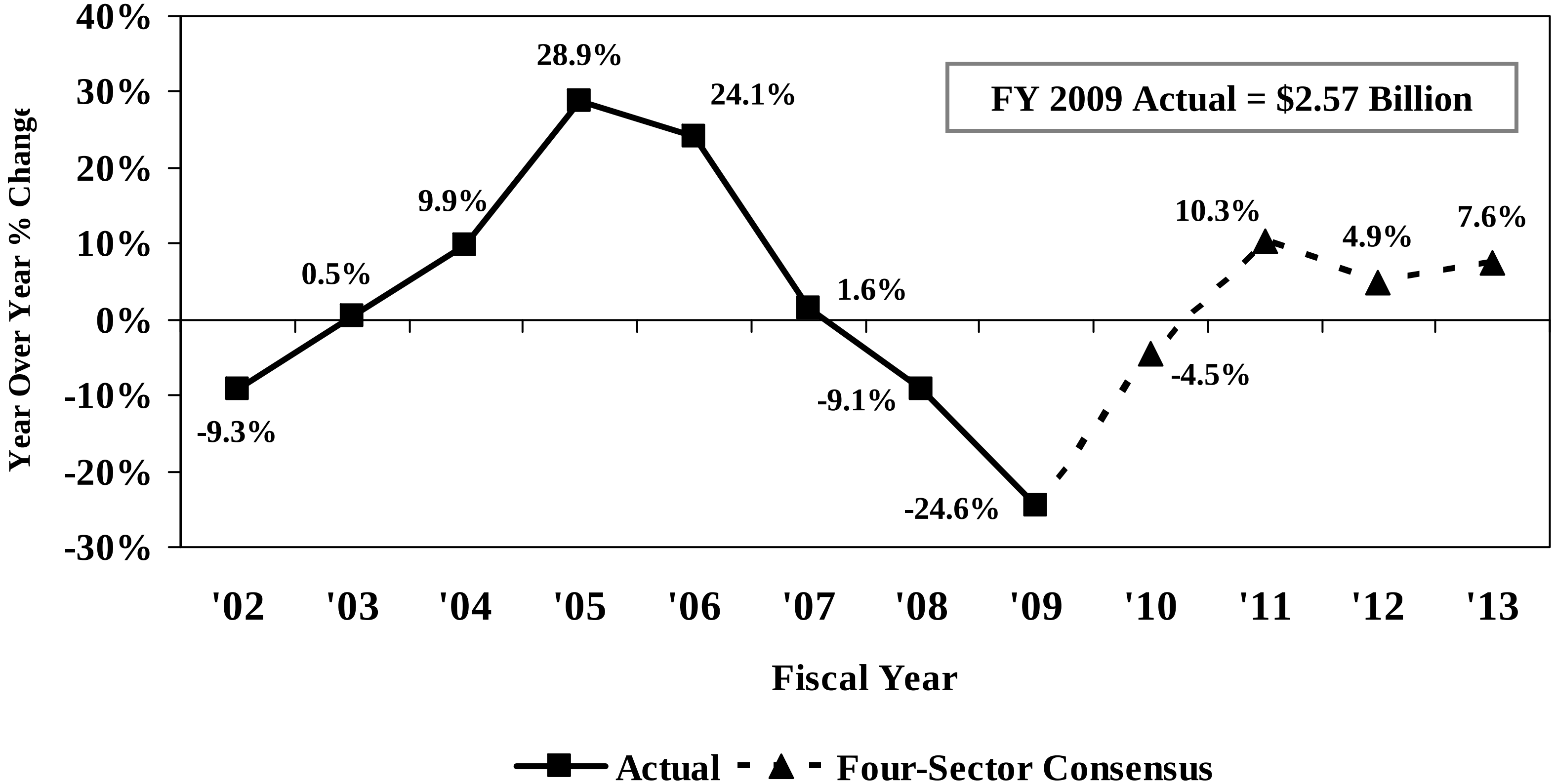
Individual Income Tax

- The Consensus Forecasts Decline of (4.5)% in FY '10, with Positive Growth Rates Beginning in FY '11



* Excluding the 10% phased-in rate reduction, growth would have been 6.3% in '07, and (4.1)% in '08.

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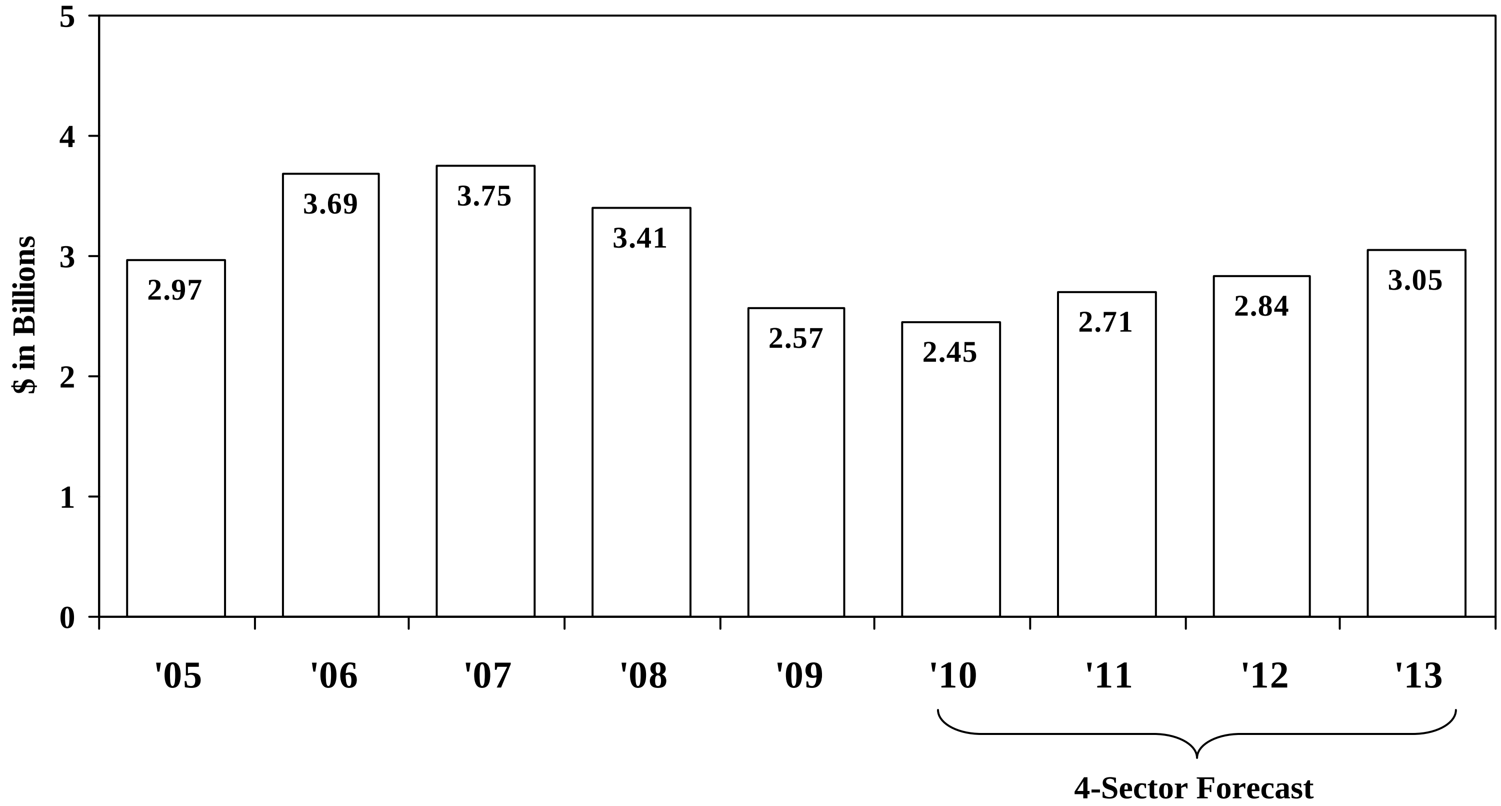
Individual Income Tax

- Collections Reach FY ’05 Level in FY ’13



Includes enacted tax law changes.

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Income Tax Continues Record Losing Streak in 1st Quarter

- Data Available from 1960

- Estimated payments declined for the 10th consecutive quarter (previous record = 4 qtrs.)

- Withholding fell for the 7th consecutive quarter (previous record = 4 qtrs.)

- Arizona's withholding and estimated payment decline was the 3rd worst in the nation

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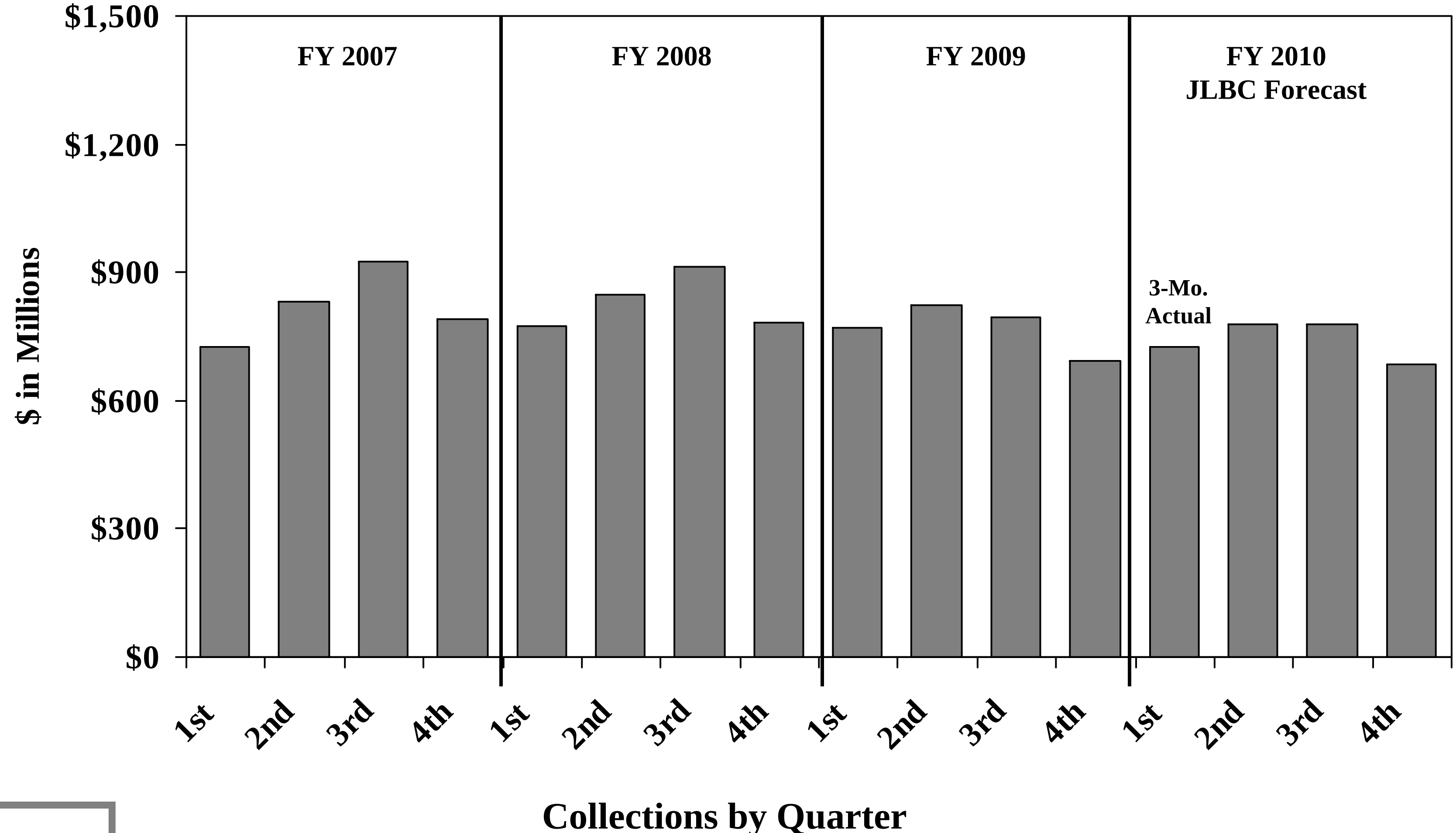
As With Sales, Withholding Appears to Have Bottomed Out

- More Difficult to Project Estimated Payments



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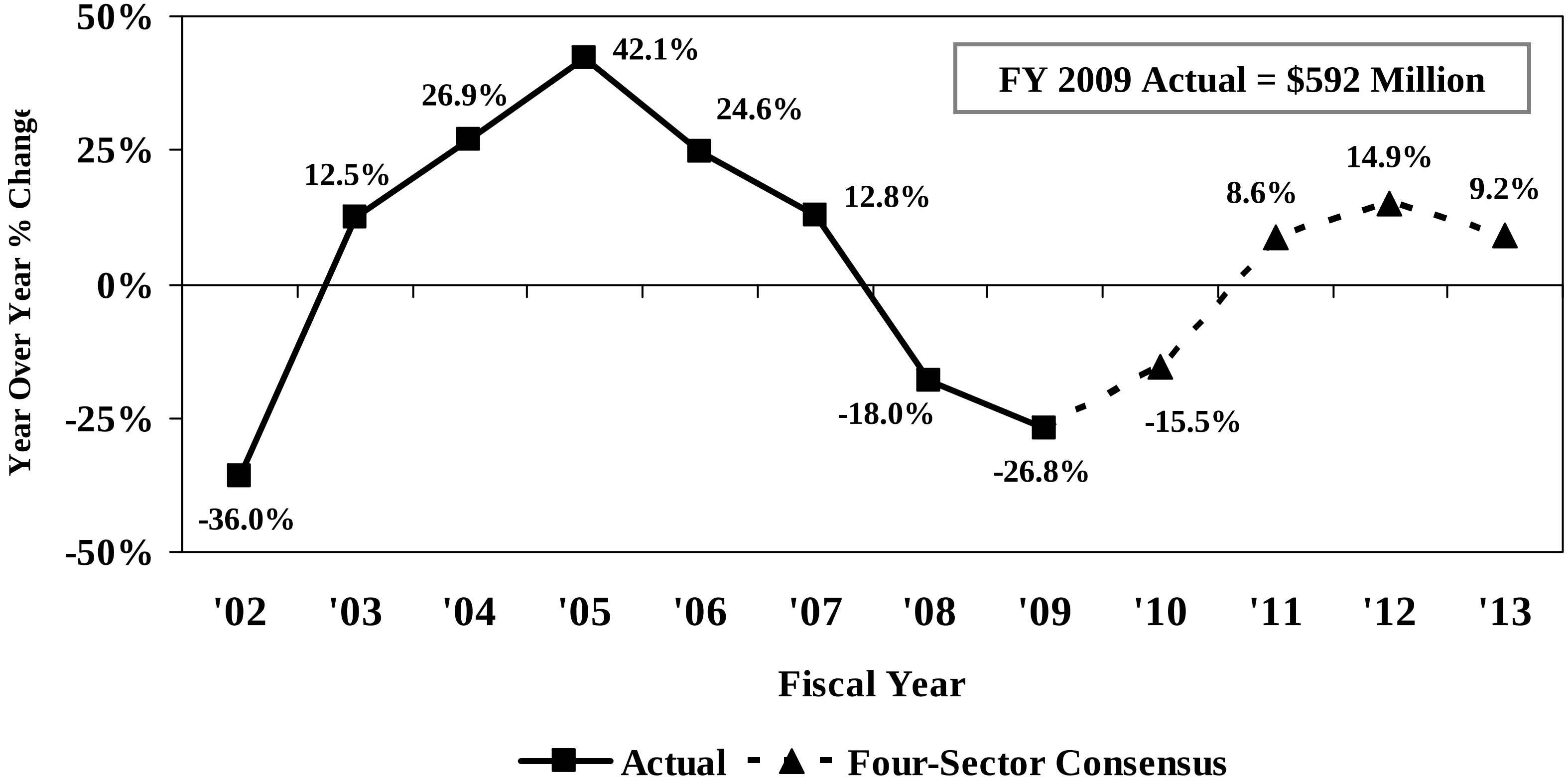
Corporate Income Tax

- The Consensus Forecasts Decline of (15.5)% in FY ’10, with Positive Growth Rates Beginning in FY ‘11



* The ’08 – ‘11 percentages include the impact of the consolidated reporting credit and the phase-in of the corporate sales factor. Excluding these tax law changes, baseline growth for ’08 – ’11 would be (14.4)%, (20.7)%, (9.9)% and 14.4% respectively.

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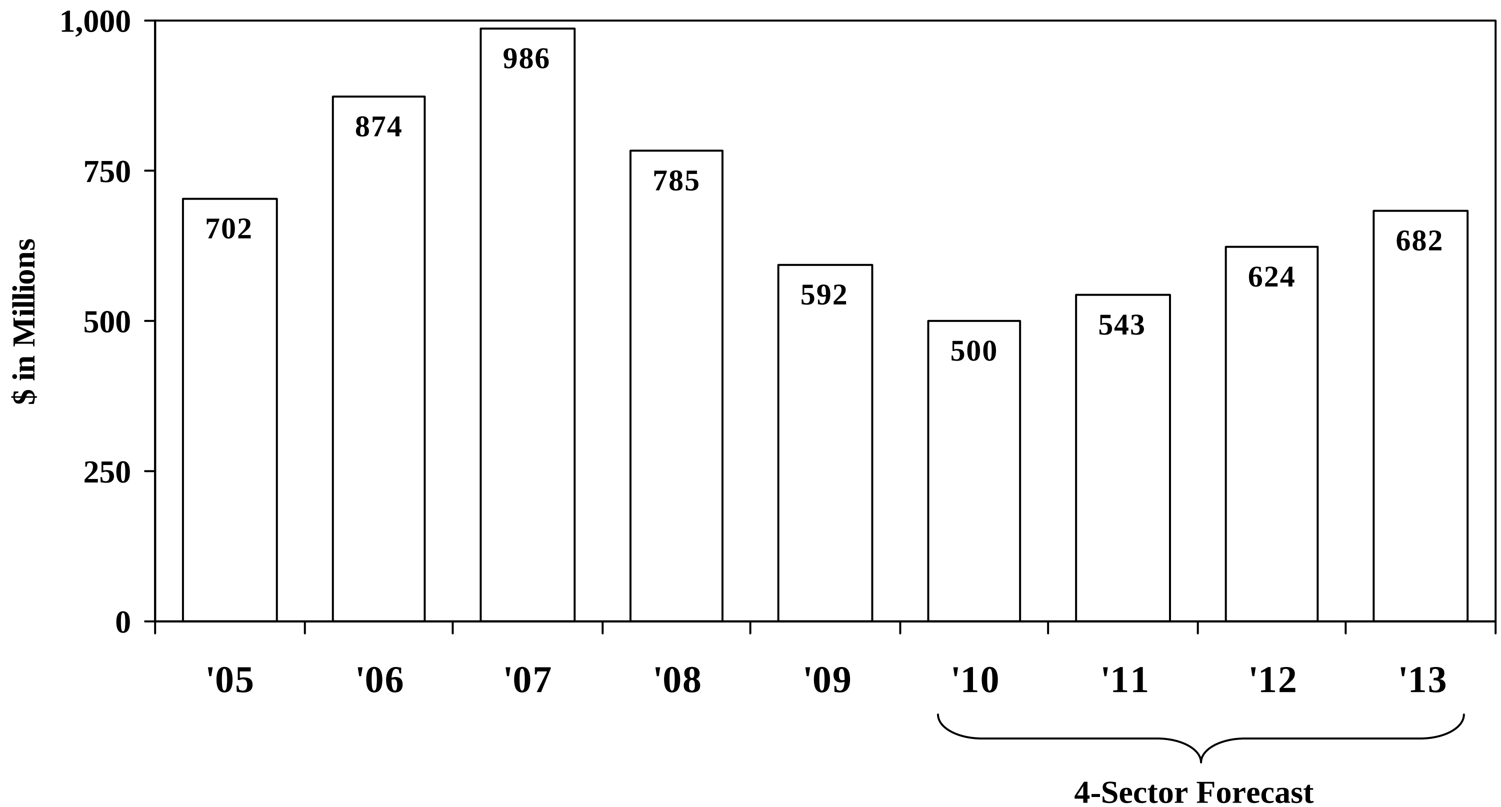
Corporate Income Tax

- FY '13 Collections Below FY '05 Level



Includes enacted tax law changes.

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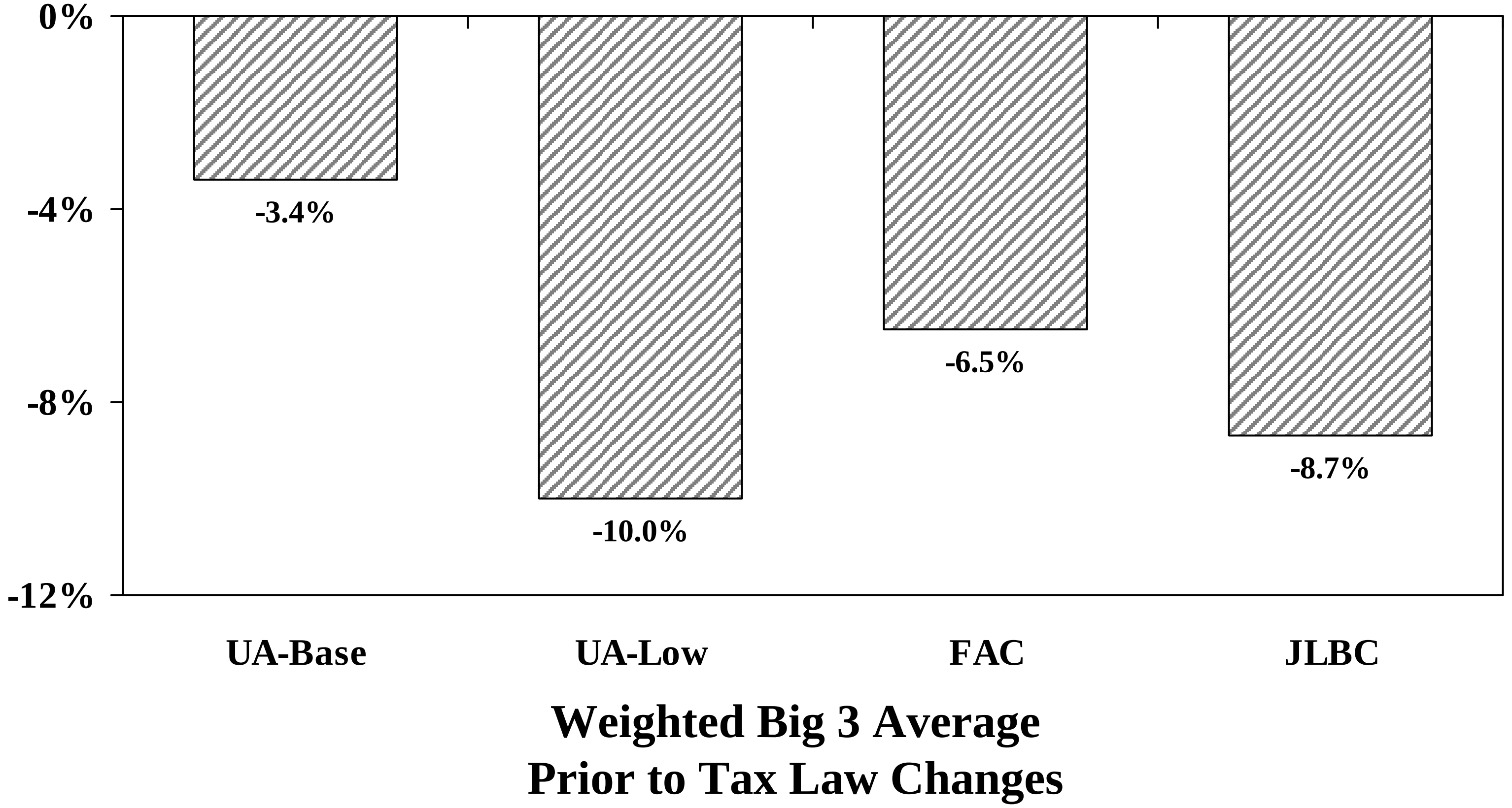
October 4-Sector Projecting Revenue Decline of (7.2)% in FY '10

- Enacted Budget Forecast for FY '10 was 0.9% Increase



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Rather Than Consensus, JLBC Recommends Using Its (8.7)% FY '10 Forecast

- Better to be cautious and improve rather than to see it get worse
- Equates to (4.9)% decline in remaining 9 months rather than (3.5)%
- After adjusting for changes in smaller categories, FY '10 forecast is (8.2)%
- Results in $(698) M revenue shortfall

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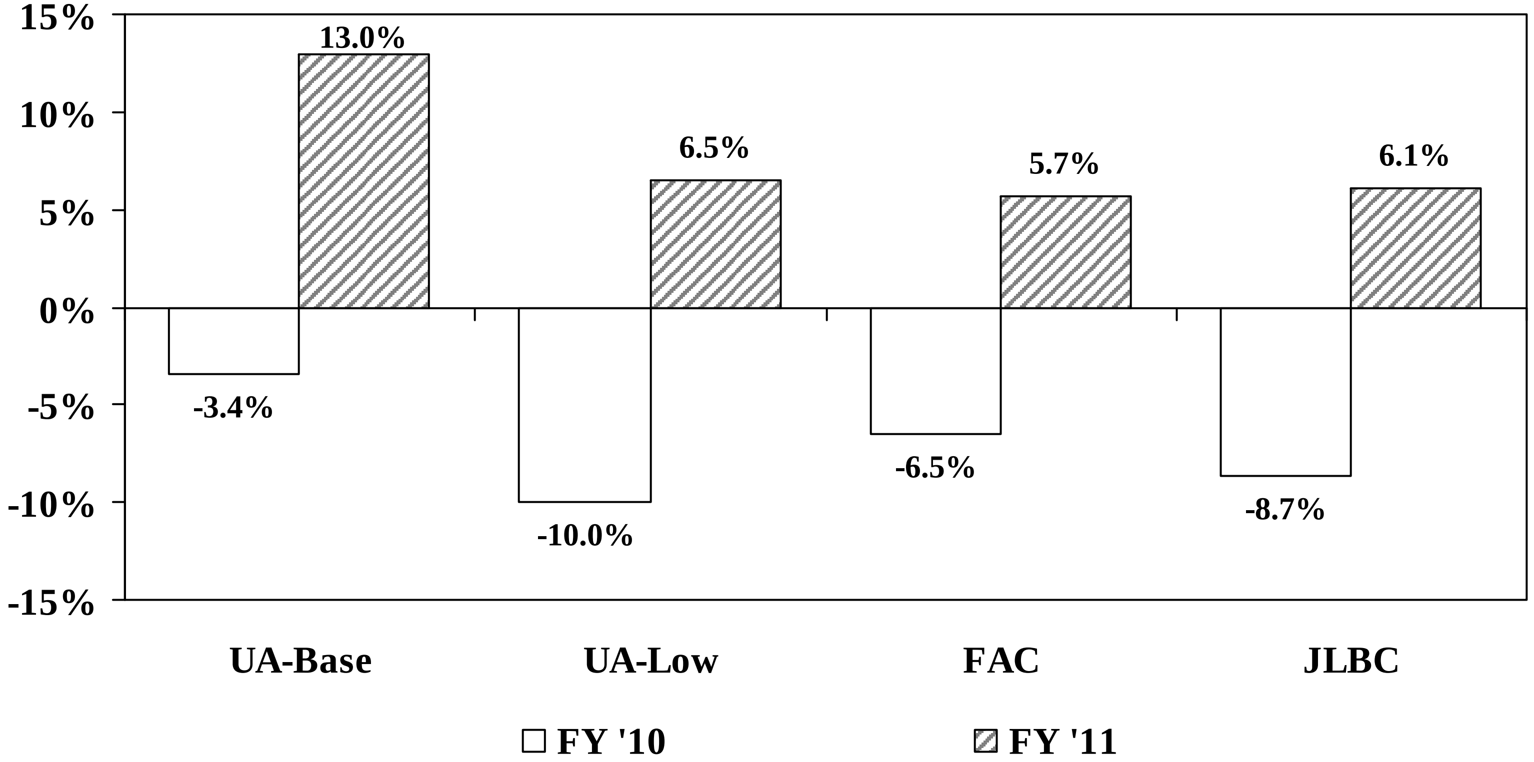
7.8% Consensus Forecast Growth for FY '11

- UA 13% Gain is the Outlier



Weighted Big 3 Average
Prior to Tax Law Changes

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FY ’11 Revenue Base Also Adjusted for Tax Laws and Urban Revenue Sharing

- Enacted tax law changes of $(45) M
  - Corporate sales factor phase-in $(29) M
  - Phoenix Convention Center payment $(5) M
  - Research and Development tax credit $(6) M
  - Solar tax credit $(5) M – 1st year difficult to predict
- Urban Revenue Sharing decreases by $(115) M from $629 M in ’10 to $474 M in ’11
  - Due to lagged decline in income tax collections

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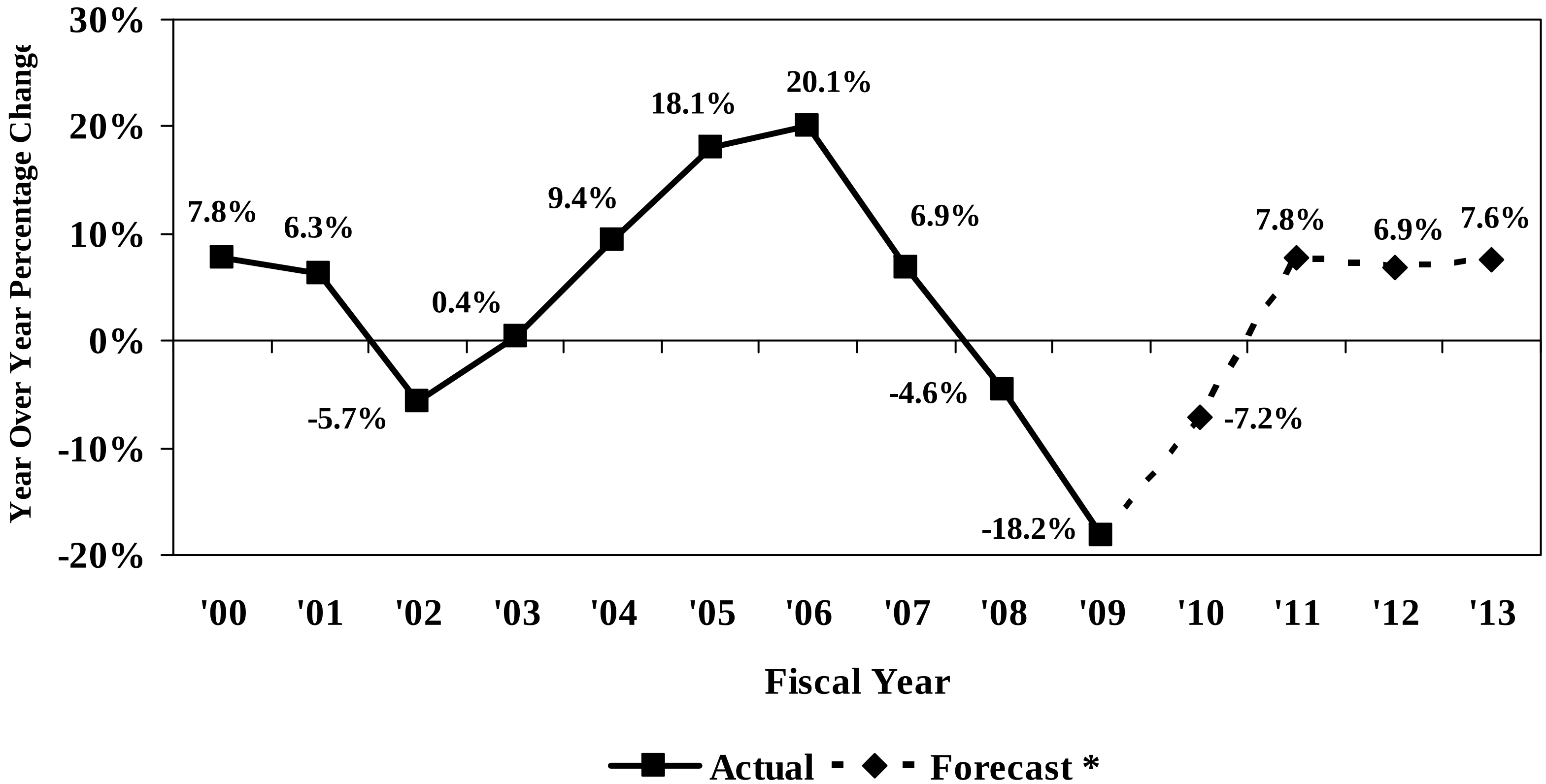
Consensus Forecasts 7% Growth Through FY '13



* 4-sector forecast weighted average growth.

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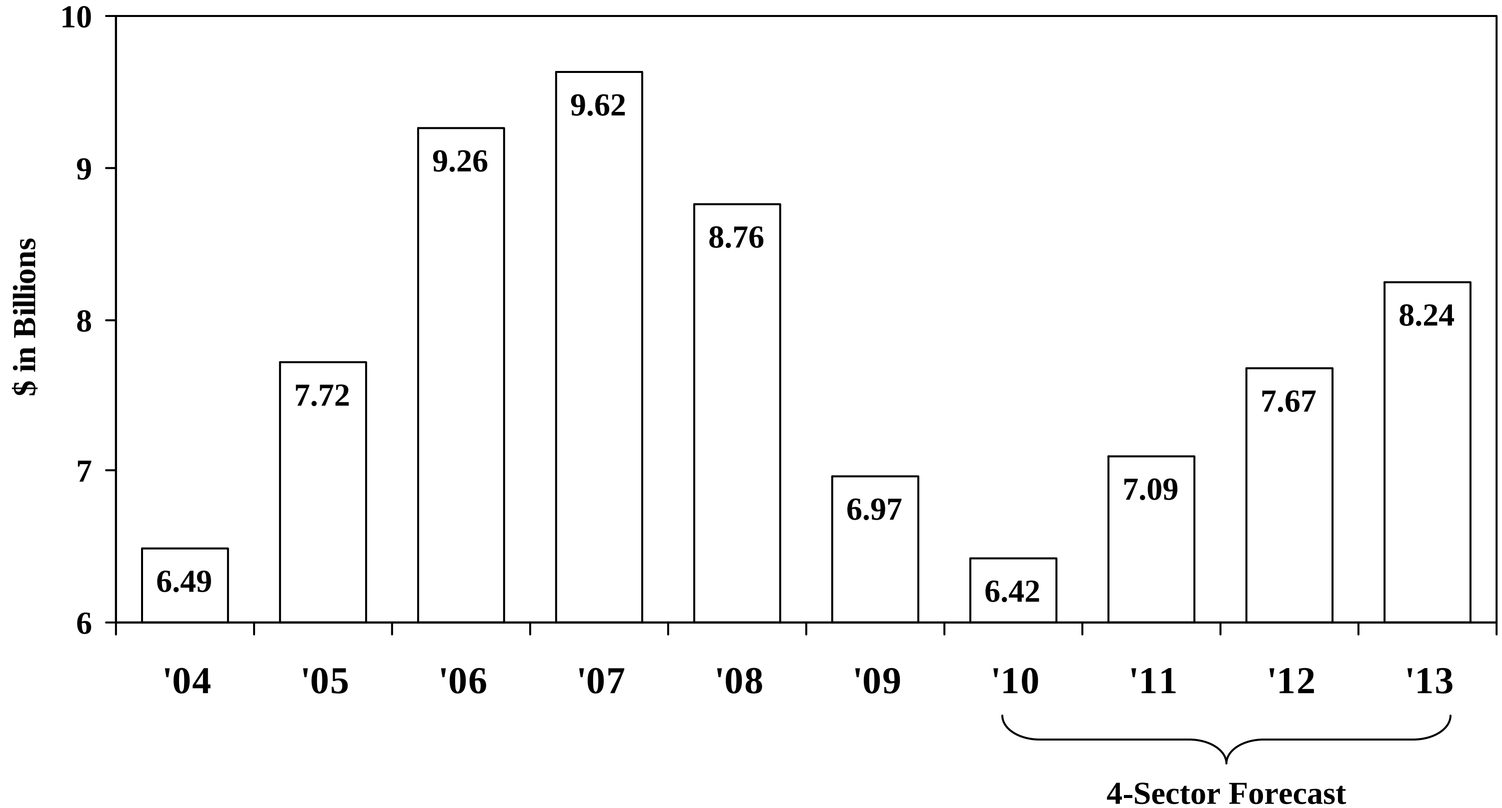
’10 & ’11 Forecast of $6.4 B - $7.0 B is Below ’05 Level

- Would Require 10% Annually through ‘14 to Reach ‘07



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

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Warning and Caveat

- Is it responsible to base a budget on 7.8% estimated growth in FY ‘11?

- Economic forecasting has limited ability to predict future, especially in unprecedented times

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FY2010-FY 2013 Quartile Forecast Worksheet

	FY 2010	FY 2011	FY 2012	FY 2013
Sales Tax				
JLBC Forecast (10/09)	-7.0%	4.9%	7.9%	8.0%
UA - Low (9/09 revision)	-10.7%	5.0%	6.1%	7.2%
UA - Base (9/09 revision)	-7.4%	7.8%	8.2%	8.1%
FAC (10/09 Survey)	-5.7%	6.2%	6.3%	5.8%
Average:	**-7.7%**	**6.0%**	**7.1%**	**7.3%**
Individual Income Tax				
JLBC Forecast (10/09)	-8.7%	6.2%	7.0%	7.0%
UA - Low (9/09 revision)	-8.1%	10.0%	-0.2%	8.4%
UA - Base (9/09 revision)	3.4%	20.1%	4.8%	8.3%
FAC (10/09 Survey)	-4.7%	4.7%	8.1%	6.7%
Average:	**-4.5%**	**10.3%**	**4.9%**	**7.6%**
Corporate Income Tax				
JLBC Forecast (10/09)	-19.8%	14.6%	6.0%	4.2%
UA - Low (9/09 revision)	-14.2%	0.5%	21.9%	13.3%
UA - Base (9/09 revision)	-8.0%	11.7%	18.7%	8.6%
FAC (10/09 Survey)	-19.8%	7.6%	12.8%	10.7%
Average:	**-15.5%**	**8.6%**	**14.9%**	**9.2%**

	FY 2010	FY 2011	FY 2012	FY 2013
Consensus Weighted Average:	**-7.2%**	**7.8%**	**6.9%**	**7.6%**
JLBC Weighted Average:	**-8.7%**	**6.1%**	**7.4%**	**7.3%**
UA Low Weighted Average:	**-10.0%**	**6.5%**	**4.9%**	**8.2%**
UA Base Weighted Average:	**-3.4%**	**13.0%**	**7.6%**	**8.2%**
FAC Consensus Weighted Average:	**-6.5%**	**5.7%**	**7.5%**	**6.5%**

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Forecast percentages are prior to tax law changes.

How Does New Forecast Affect Budget Shortfall?

New Forecast Raises FY ’10 Shortfall to $2.0 B

	$ in M
• FY ’09 Carryover Shortfall	$ 478
• FY '10 Budgeted Shortfall after Vetoes	483
• FY ’10 Revenue Shortfall – Oct. Forecast	698
• AHCCCS/DHS Caseloads	135
• Mark-Down of Savings Estimates	165
– AHCCCS Fraud, Concession Agreement, Sale/Lease-Back	
• Total	$1,959

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There Are 3 Measures of State's Fiscal Condition

- General Fund Budget Balance
- General Fund Structural Balance
- Operating Fund Balance
  - the actual checkbook

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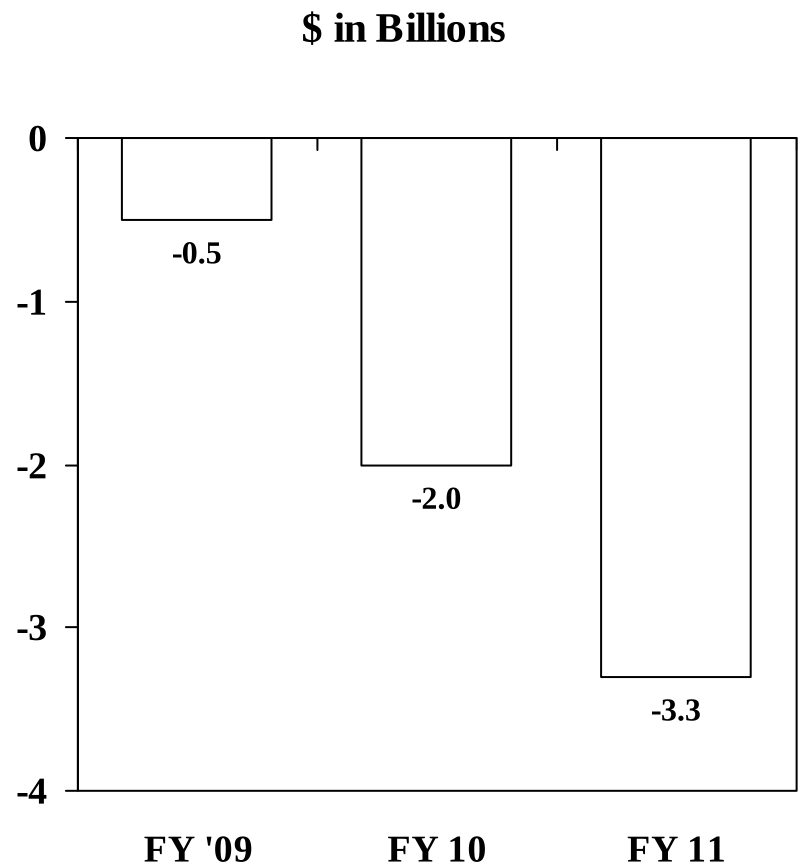
General Fund Balance

- Represents Financial Condition on the “Balance Sheet”

- ’09 1st negative year in memory
- ’10: vetoes, lagging revenues, ’09 carryover
- ’11: projection based on current trends
- ’11 shortfall assumes no ’10 carryover
- Any on-going ’10 solution reduces ‘11



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Doesn't State Have A Balanced Budget Requirement?

- Arizona Constitution requires Legislature to provide revenues to "defray" the necessary expenses for each year
- If the state falls short, the Legislature may tax in the following year to make up difference

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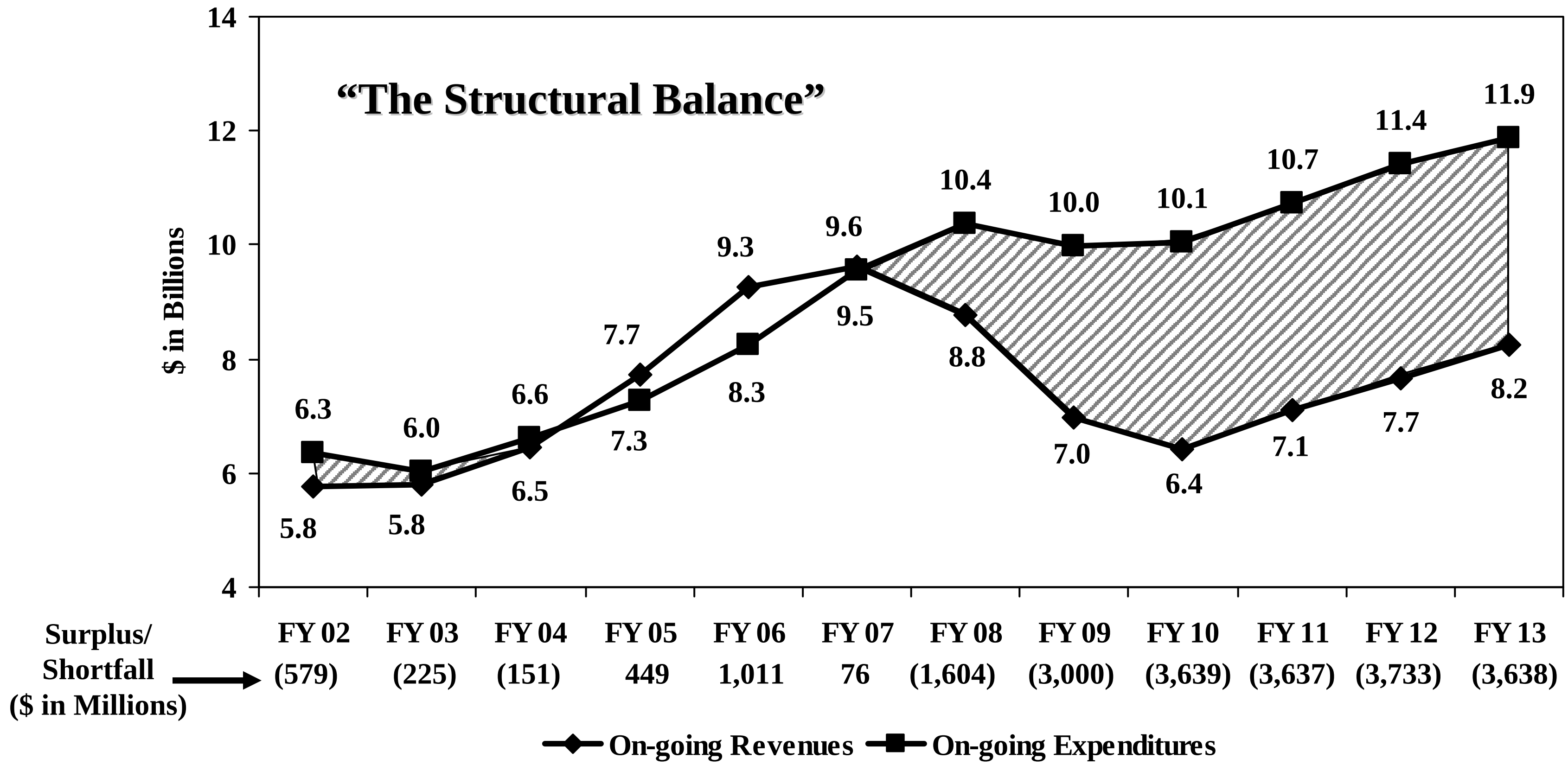
Fiscal Condition Also Measured by On-Going Revenues vs. Spending

- Gap is Filled by One-Time Solutions



*Based on current FY '10 estimates.

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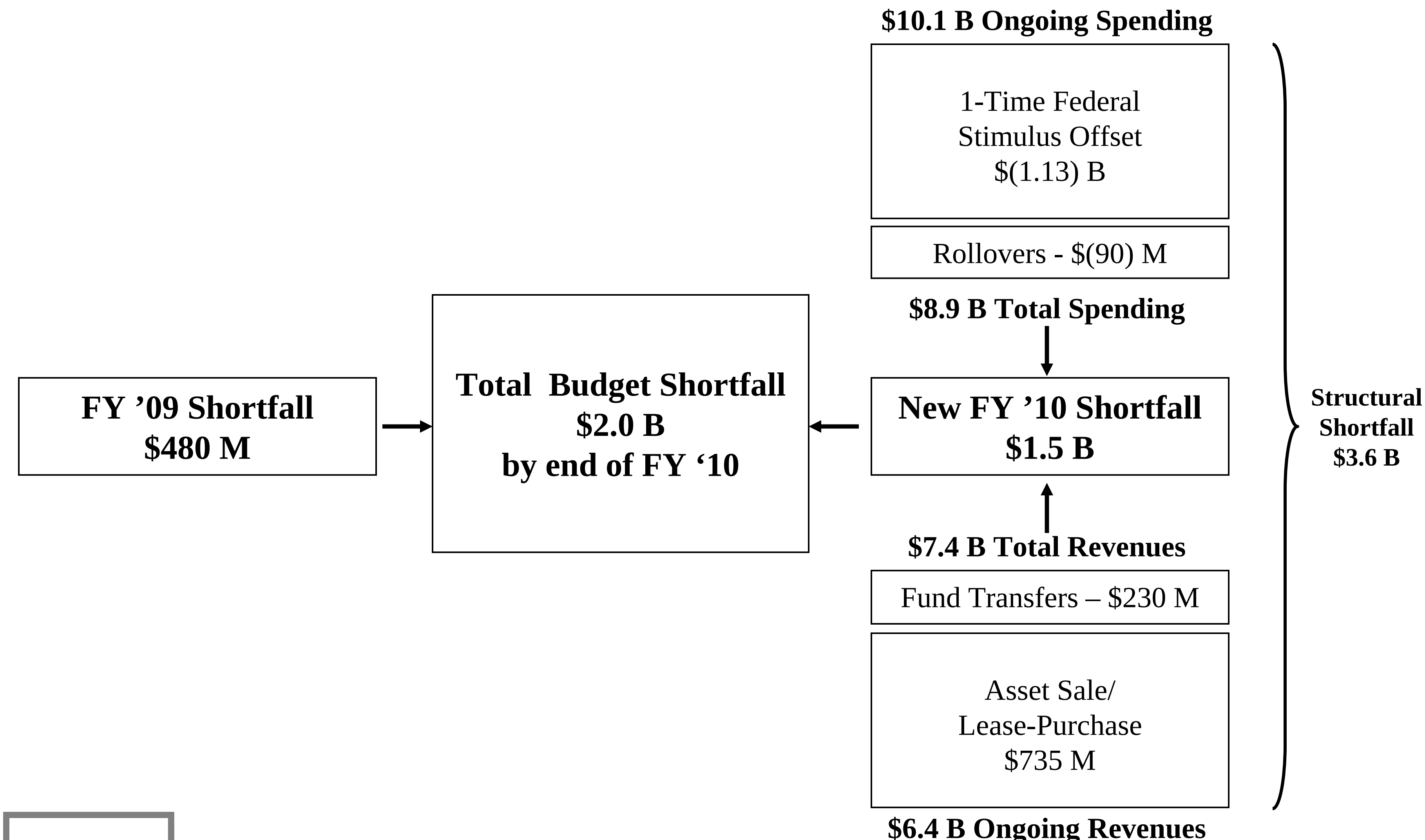
The Budget and Structural Shortfalls



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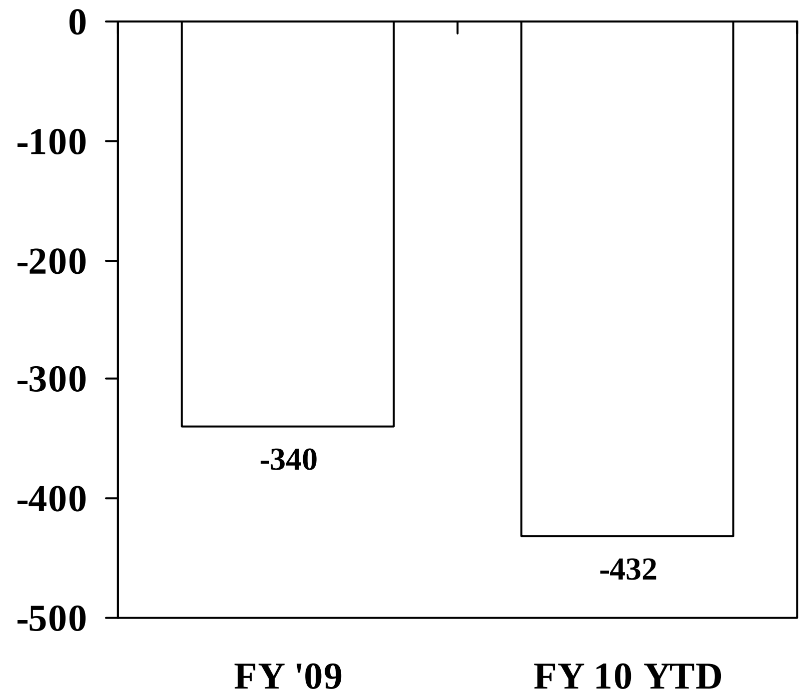
The Operating Fund Balance Went Negative in '09
- 1st Time Since 1930's

- State pays its daily bills from Operating Fund
- Includes $1.6 B in non-General Fund accounts
- When negative, state borrows daily
- First intrafund, then commercial

Single Highest Daily Shortfall
$ in Millions



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Operating Fund Borrowing is the Last Back-Stop

- State is issuing long-term debt to generate cash for budget-balancing
  - e.g., $735 M state building leaseback

- The Operating Fund borrowing, however, is overnight debt solely to pay that day's bills

- At some point, banks won't lend anymore – the California experience

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Moody's Shifted Rating Outlook to "Negative"

- Accompanied by Following Observations

- The state has taken some steps to stabilize its fiscal situation
- Statutory limits prevent quick action on shortfalls
- Most balancing measures "are not of a recurring nature"
- "Available reserves have been depleted"
- The state faces the "challenge of addressing ongoing structural imbalance with more limited resources, in an environment of continuing economic weakness"

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