

Budget Overview

Greater Phoenix Chamber of Commerce

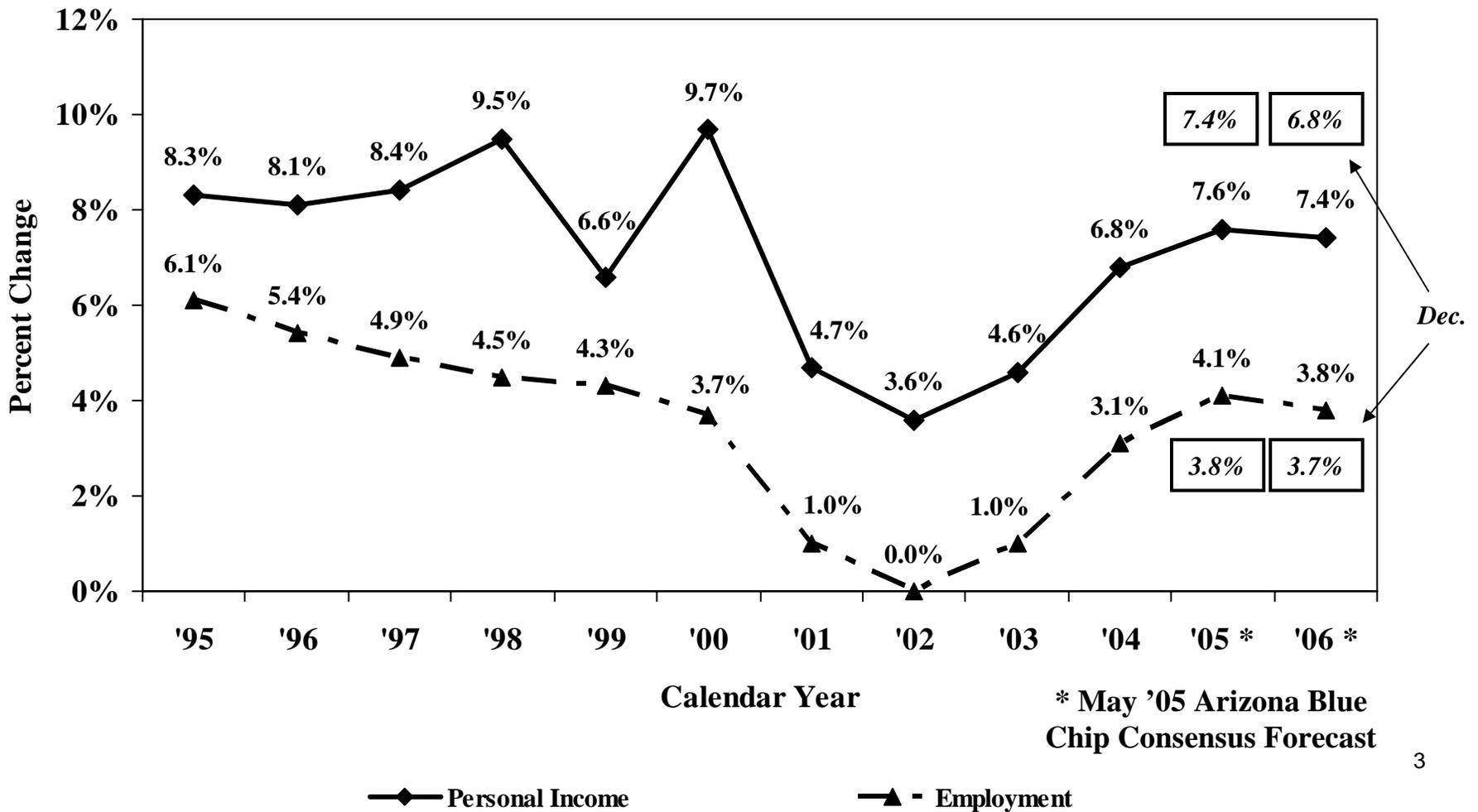
July 13, 2005

General Fund Revenues – the Recent Good News

- Combined April & May collections exceeded the forecast by over \$250 M.
- April's \$1.1 billion of receipts represented the single highest month of collections.
- Combined April/May individual income tax collections grew by 75%.
- Nationwide, Spring tax revenues were higher than expected -- although Arizona's growth was near the top of the list.

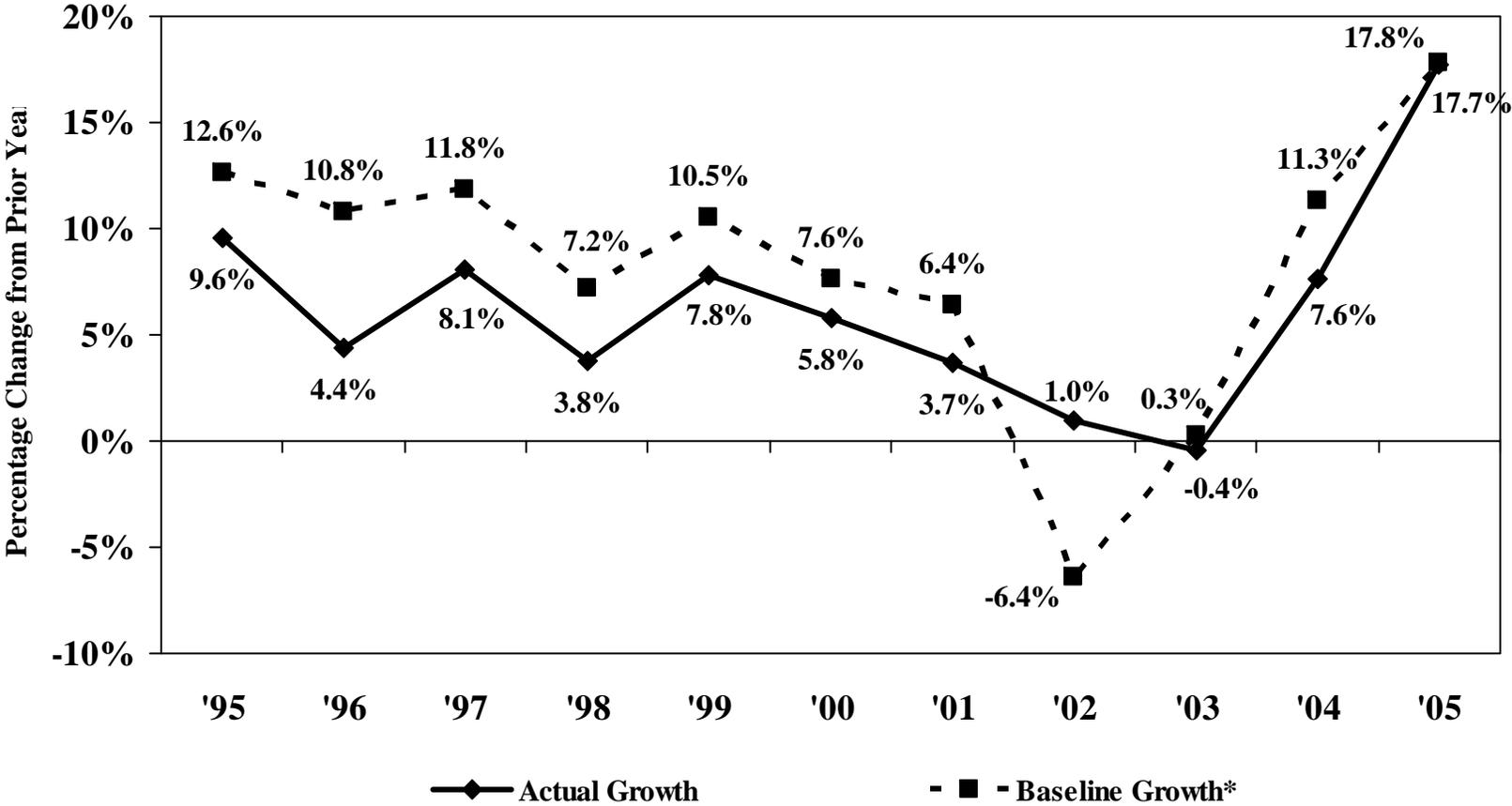
What is the State of the Arizona Economy?

- Blue Chip Consensus Projects Continued Growth
- Projections Have Not Changed Significantly in Last 6 Months
- Estimates Are Probably Not Capturing Real Estate Impacts



Year-to-Date FY 05 Revenue Growth is 17.7%

- Revenues are growing much more quickly than personal income
- Current expansion has outpaced 90's, at least for '05

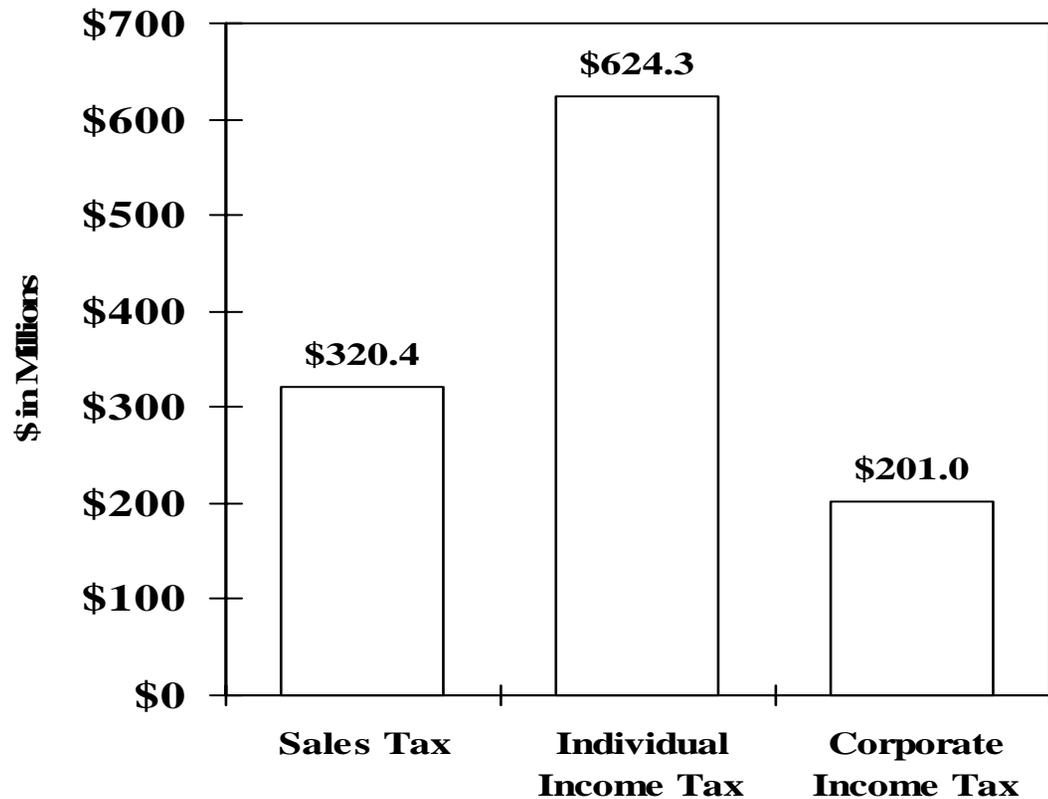


*Baseline growth reflects growth rate prior to tax changes, but does not account for dynamic impact of these changes.

Major Tax Collections are \$1.1 Billion Higher than Last Year

- Individual and Corporate Especially Strong

- 10.6% - Sales Tax Growth
- 30.2% - Individual Income Tax Growth
- 49.8% - Corporate Income Tax Growth



May YTD - '05 Above '04

Business Profitability and Real Estate Fuel Growth

- Business profitability affects both corporate and individual income tax collections -- small businesses increasingly pay the individual tax.
- If small businesses are experiencing same growth as corporations, they could account for 50% of the increase in individual income tax final payments.
- Businesses may have taken advantage of bonus depreciation at the federal level, but there is no state benefit.
- Investor real estate and stock market capital gains also boosted individual collections – for example, Microsoft had a \$32 billion dividend distribution.
- Another outcome of real estate boom -- contracting sales tax receipts are up 19.5% compared to last year.

Short-Term Gains May Not Translate into Long-Term Revenues

- Corporate and non-withholding individual income collections are historically volatile -- they dropped a combined \$400 million in last recession.
- Real estate unlikely to maintain its current pace -- thereby making some recent revenues one-time.
- Recent tax package will have a significant long-term impact on revenues.

Tax Reductions Total \$18 M in '06

- Could Grow to Over \$200 M When Fully Implemented

- The new tax reductions total \$18 M in '06, including:
 - Elimination of the marriage penalty on certain tax credits.
 - Inflation adjustment for income tax standard deduction.
 - IRS tax code conformity.
- Reduction in business property tax will be phased in over 10 years at an ultimate cost of \$140 M.
- The new corporate tax sales factor calculation could reduce existing revenues by \$120 M in 2011.
- New motion picture tax credits are capped at \$70 M by 2010, but difficult to project activity in advance.
- Overall long term tax package impact will depend on level of new economic activity generated by lower taxes.

How Did We Forecast FY 06 General Fund Revenues?

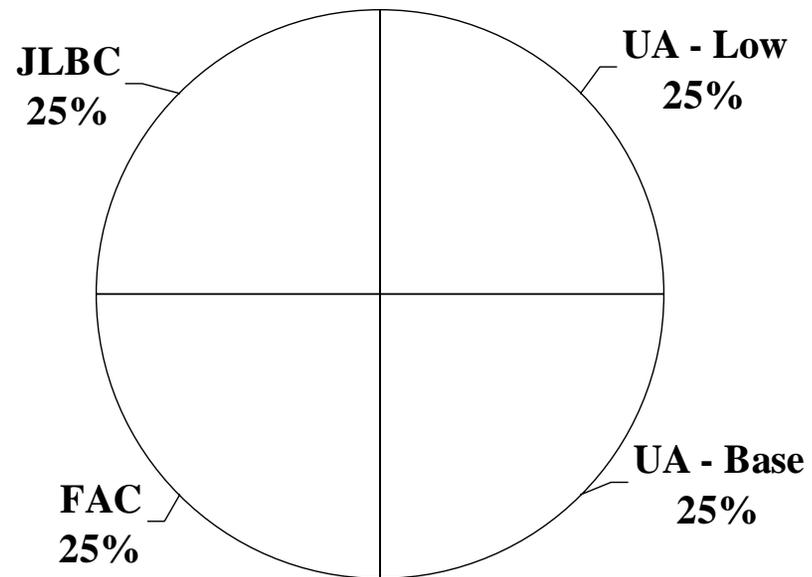
-- Use of a Consensus Process

-- Executive Estimates were originally lower, then adjusted to Consensus level.

“Big 3” tax forecast equally weights:

- Finance Advisory Committee
- UofA model - base
- UofA model - low
- JLBC Staff forecast

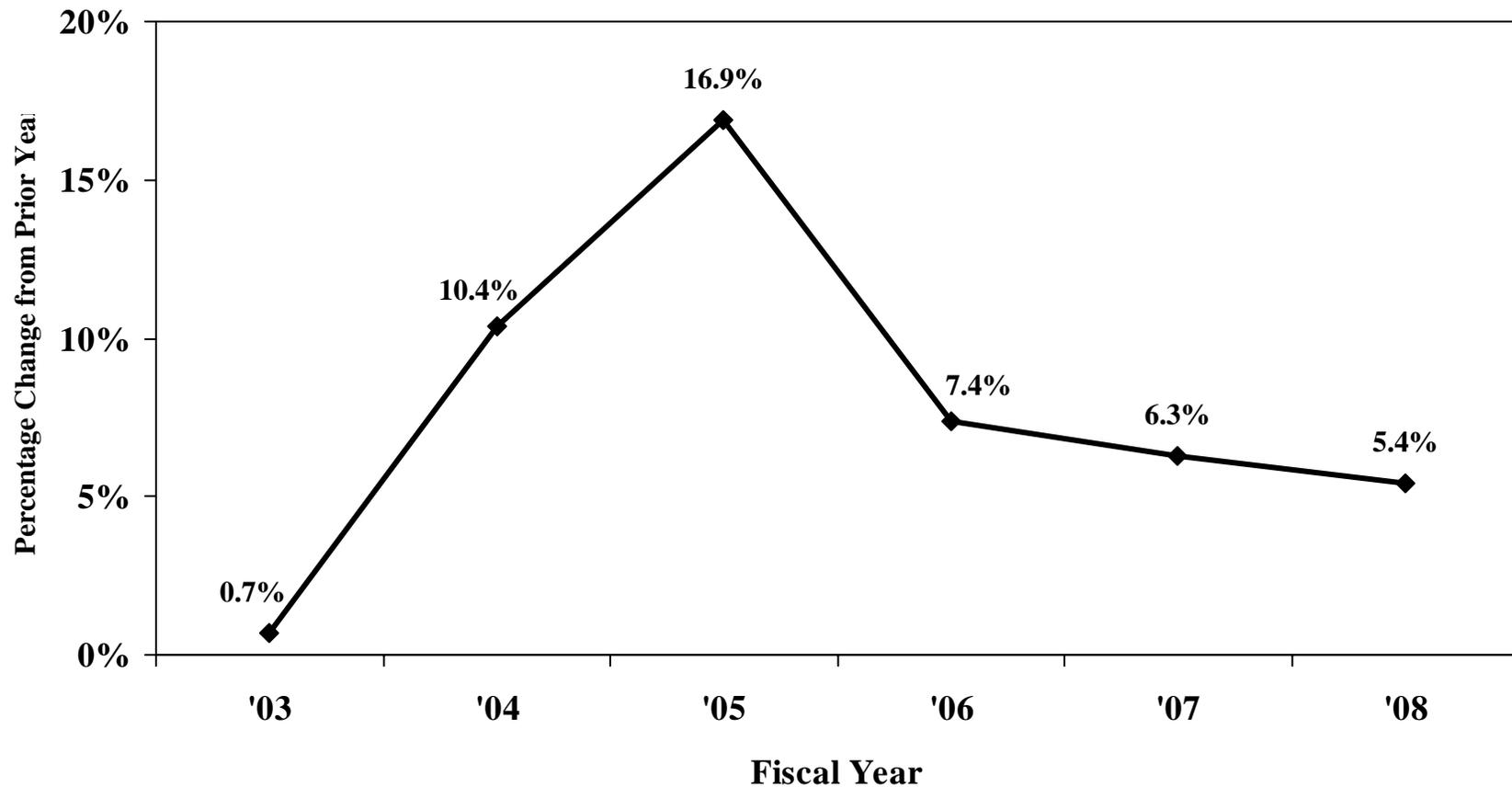
Remaining revenues (6% of total) are staff forecast



In FY 04, these 3 revenues grew by 10.4%. The UofA base model, which forecasted 7.8% growth, came closest to predicting actual growth.

How Much Revenue Will Be Available?

Consensus Rate of 7.4% in '06 Will Need to be Revisited in Light of '05 Performance

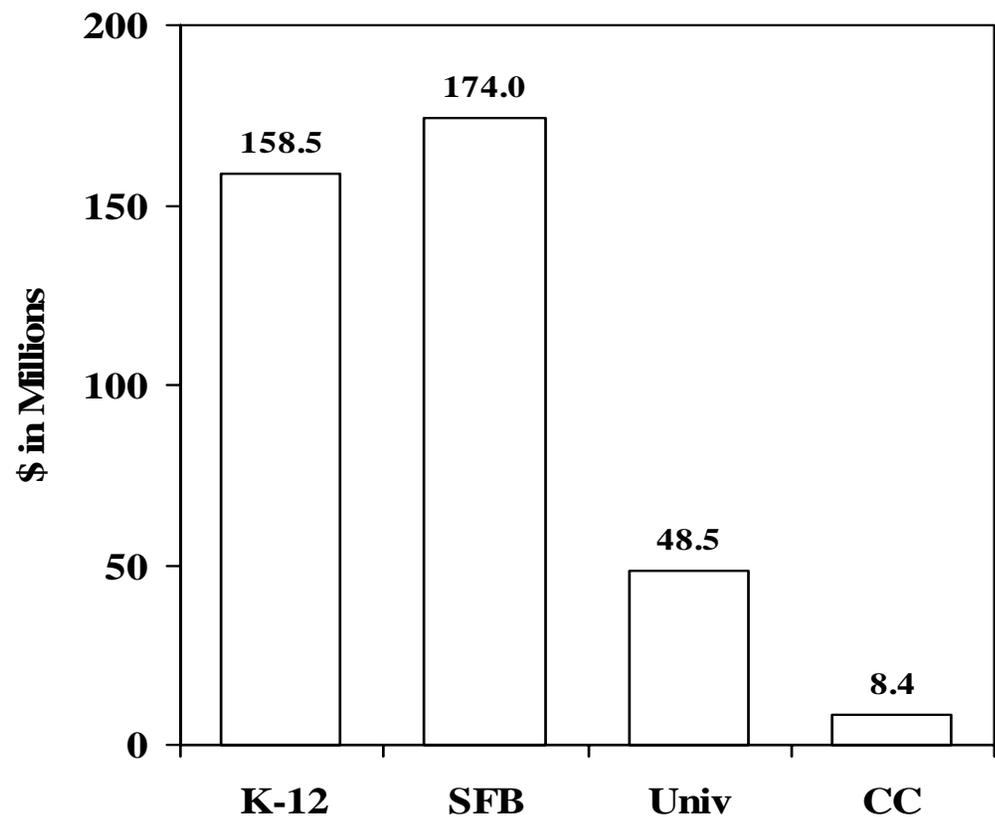


(excludes urban revenue sharing)

FY 2006 Spending Changes

Education Spending Increases by \$389 M

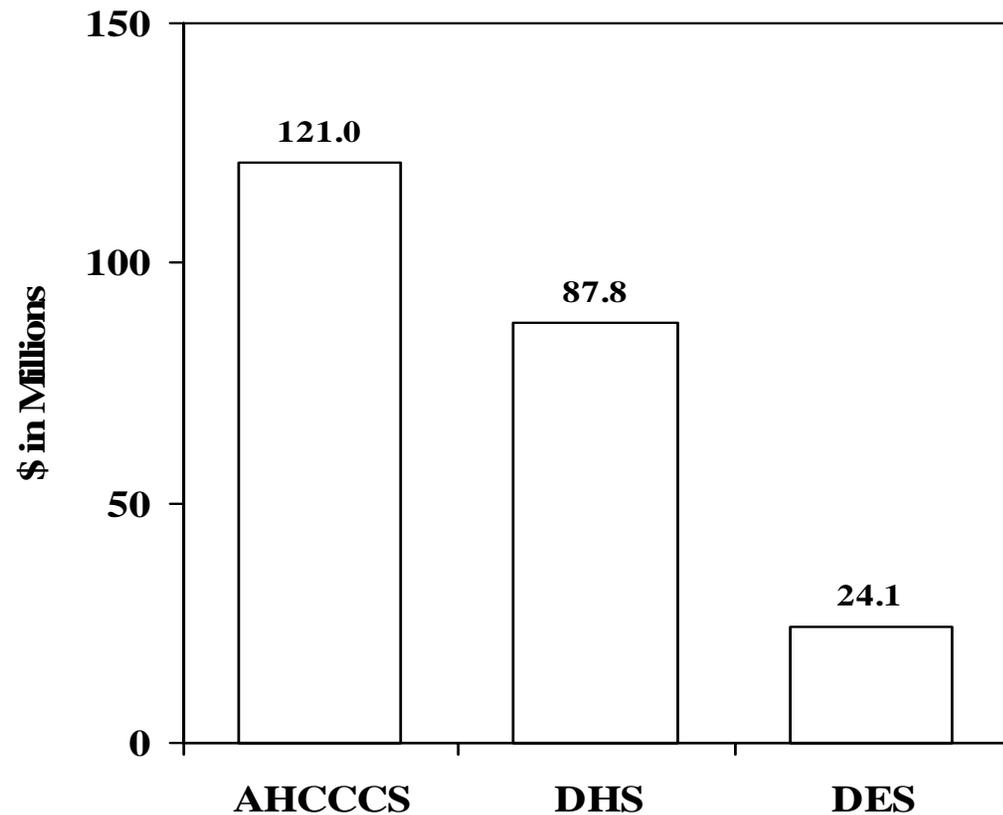
- Fully funds K-12 enrollment formula and 3.2% inflation.
- SFB new school construction is cash rather than debt financed.
- University and Community College formulas are fully funded.
- Phoenix Medical School receives \$7 million



'06 General Fund Increases above '05

Health and Welfare Spending Increases by \$233 M

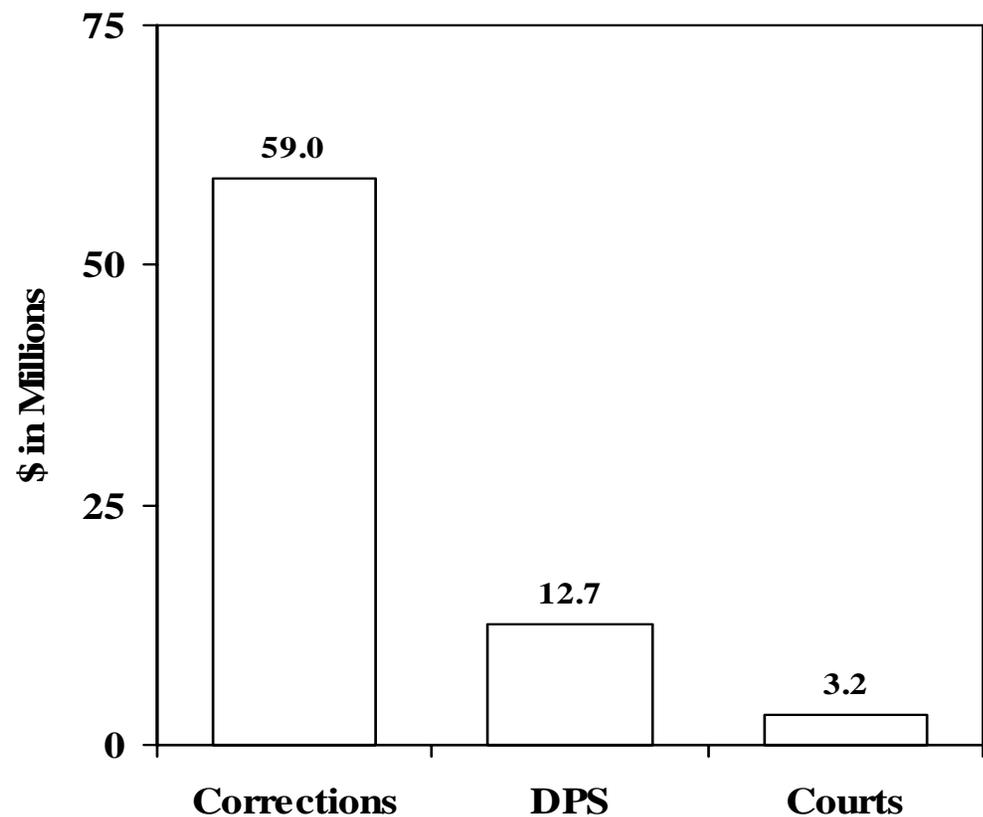
- Funds 2.5% AHCCCS caseload growth and 6% inflation.
- Adds \$11 M GF and \$17 M Other Funds for 175 CPS staff and related services.



'06 General Fund Increases above '05

Criminal Justice Spending Increases by \$75 M

- Adds 1,000 new prison beds.
- Adds 28 new Highway Patrol to DPS.



'06 General Fund Increases above '05

FY '06 Budget Includes \$43 M State Employee Pay Package

- 1.7% state employee pay raise to offset 1.7% retirement contribution increase.
- In addition to 1.7%, DPS officers receive an average of \$1,900 and assistant attorneys general receive \$4,500.
- In lieu of 1.7%, correctional officers receive \$1,410 increase.

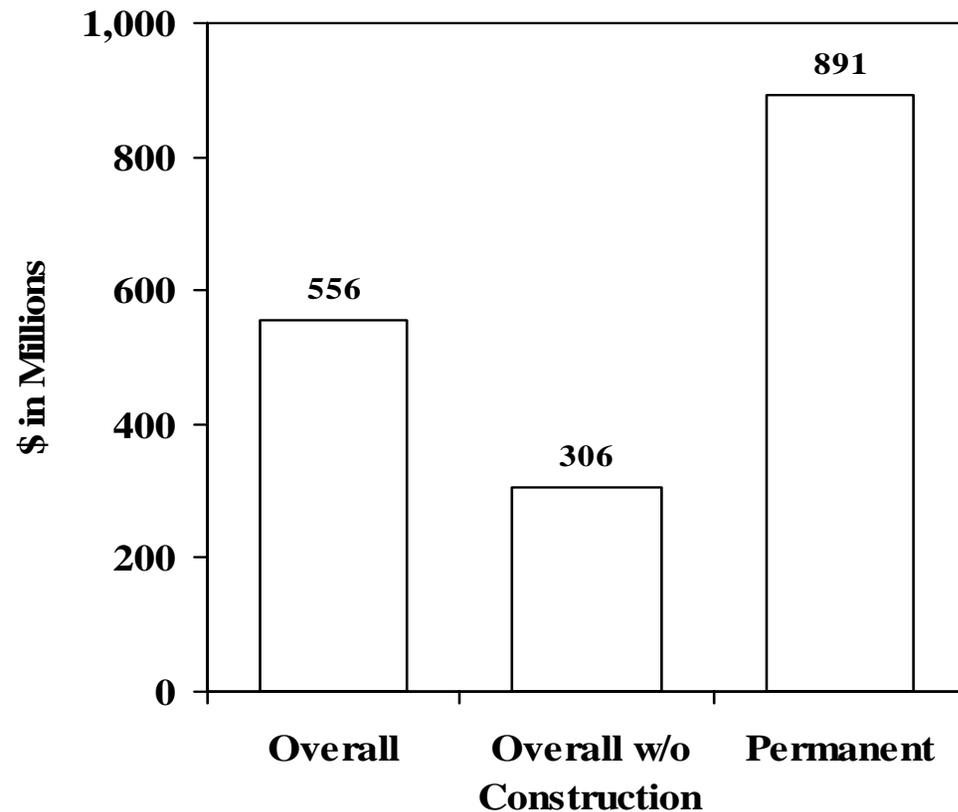
Budget Stabilization Reserve Will Be 2.1% of General Fund by the end of '05

- Prior to '05, the fund was almost depleted.
- By end of '05, \$170 M will be in the fund.
- Governor vetoed use of new excess '05 revenue collections for BSF.
- Fund will still receive '06 excess revenues.

State General Fund Budget is \$8.22 B

- Overall Growth in State Spending Varies Depending on Measurement

- Overall spending is increasing by 7.2%.
- Excluding conversion to cash financing of school construction, increase is 4.0%.
- Permanent spending is up 12.2%.



What Does Recent Revenue Surge Mean for the State Budget?

- State has returned to a position of a structural balance -- permanent revenues exceed permanent spending.
- As enacted, FY '06 budget was projected to have an ending cash balance of \$32 M.
- With recent surplus April/May revenues, '06 balance will probably be more like \$250 M.
- '06 revenues may grow faster than 7.4% consensus rate - but need to monitor possible one-time impacts of real estate boom.
- Any new '06 surplus revenue already slated for the Budget Stabilization Fund.

Will There Be Surplus Revenues to Spend in the Next Budget?

- We need to monitor progress of the economy prior to the next session.
- In developing a '07 budget, the State will first need to replace \$345 M in one-time monies used to balance '06 -- \$250 M would only partially cover that cost.
- Surplus will depend on whether new '07 revenues are sufficient to cover \$400 M - \$600 M in '07 statutory spending obligations.
- In '07, there is a \$40 M increase in the final Ladewig Litigation payment.
- State Employee Pay will be an issue again -- Most employees will have no “take home” increase in '06 and there will be another 1.7% retirement increase in '07.
- There are unresolved issues from the last budget:
 - Flores Litigation
 - Corporate Tuition Tax Credit
- Given the possibility of one-time nature of current revenues, there may be focus on one-time spending, such as:
 - Elimination the K-12 “rollover” payment to school districts.
 - Increasing the current 15% funding of State’s building repair program.