FY 2011 Year End
Revenue and Budget Update

July 27, 2011

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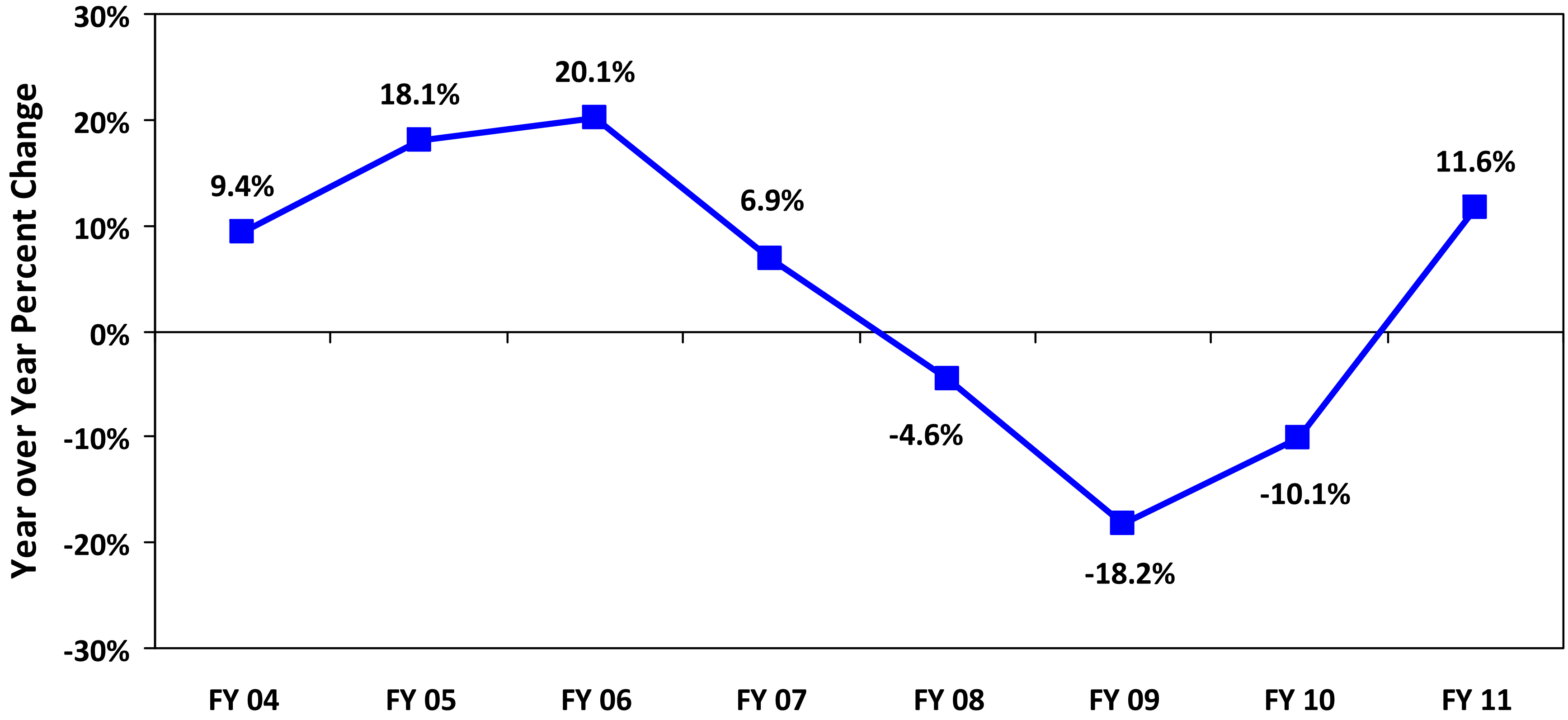
Base Revenues Grew in FY '11 for the First Time Since FY '07

- Based On Preliminary Year End Estimates



- To reflect underlying economic growth, "Base" revenues exclude balance forward, tax law changes, one-time revenues, and urban revenue sharing

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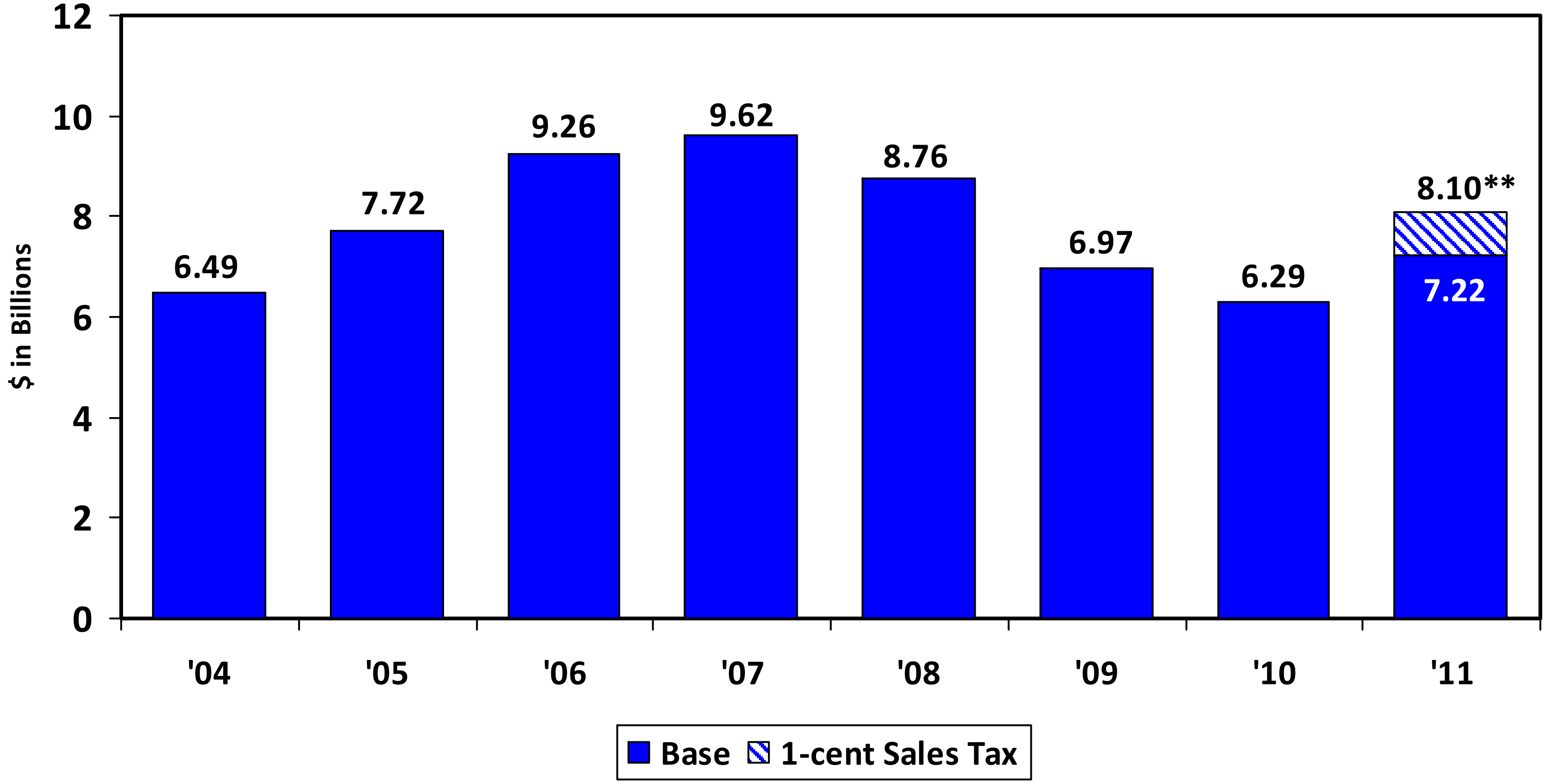
The FY ’11 Rebound Still Leaves Adjusted Base Revenues Of $7.22 B Below FY ’05 Level*



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

**Total Revenues Including One-time Adjustments Are $8.34 B

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FY ’11 12% Rebound Led By Income Taxes
- Revenues Are $335 M Above 5.6% Forecasted Growth

	FY ’11 Over ’10	
	Budgeted	Prelim. Actual
Sales*	2.9%	2.5%
Individual Income	5.9%	18.5%
Corporate Income	40.8%	35.6%

* Without 1 Cent

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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.

Individual Income Tax Is Primary Reason For Forecast Overage

- Withholding grew 7.3% in FY ’11
  - Difficult to explain growth of this magnitude
  - Job growth has been less than 0.5%
  - Average private wages have grown 2 to 3%
  - Some growth may have come from change in Arizona withholding tables last July
- Strong State withholding growth appears to be part of a nationwide trend.
  - 8.3% nationwide growth in 1st quarter of 2011 (Jan. – Mar.)
  - May be that job and wage growth are underreported

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Higher Capital Gains and Loss of Mortgage Deduction Also Increased Income Tax Liability

- Tax Payments Grew By 13.3% and Refunds Fell By (9.6)%

- While no official data is available, capital gains probably grew substantially
  - Stock market values increased by 17% in calendar year 2010
  - "Flipping" of foreclosure properties produced some profits
- Fewer taxpayers are taking advantage of mortgage interest deduction
  - Arizona itemized deductions are 30% below last year
  - $18 billion reduction in outstanding mortgage debt between calendar years 2009 and 2010.

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)	361,800*
Pending Foreclosures	51,500 (Dec. 2010)	26,473
Mortgages Underwater	51.3% (Q4, 2009)	49.6% (Q1, 2011)

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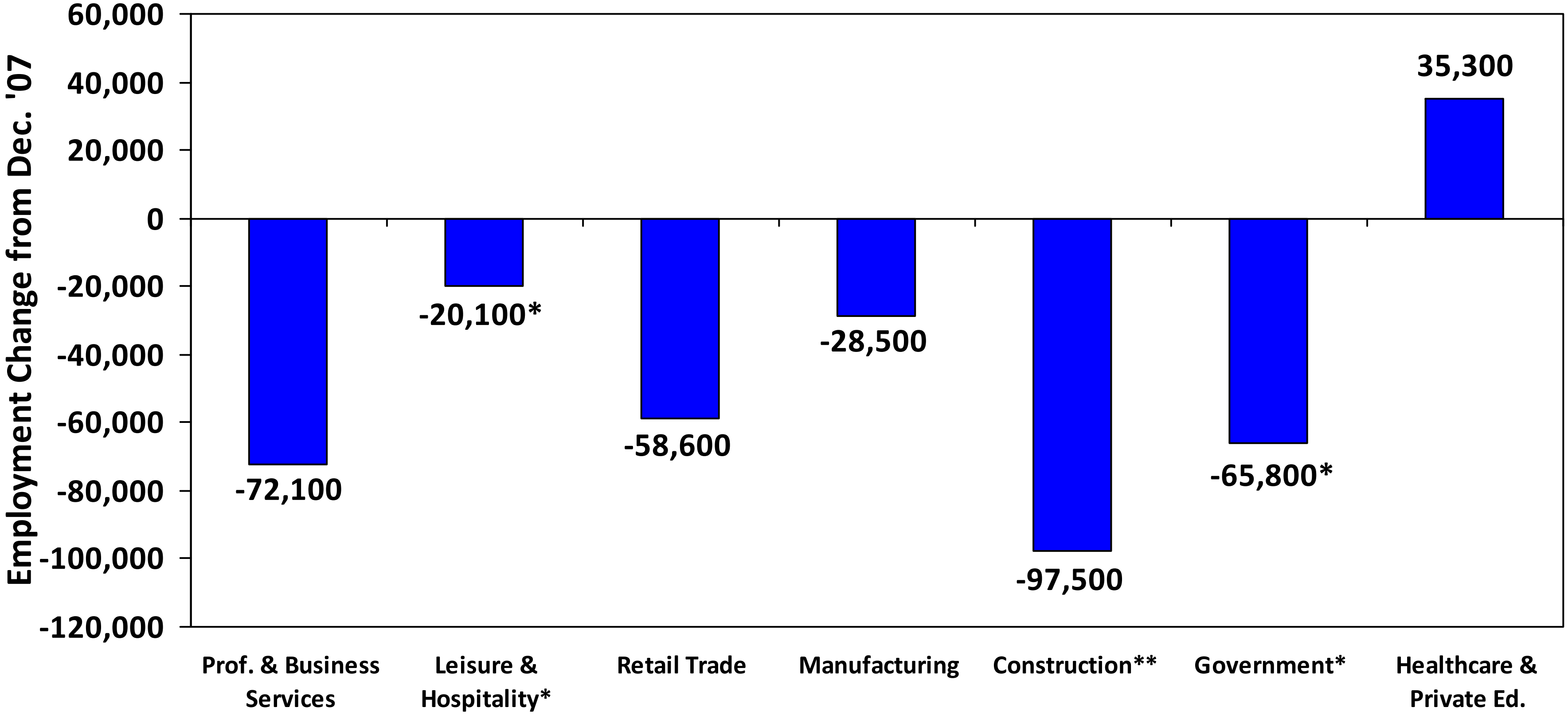
*** Due to seasonal decline of summer jobs, overstates actual loss**

Job Losses Since December 2007 by Sector
- Of 361,800 lost jobs, 97,500 were in construction



* Overstates employment loss due to summer seasonal jobs

**Construction employment peaked in June 2006. Total loss is 135,000 jobs.

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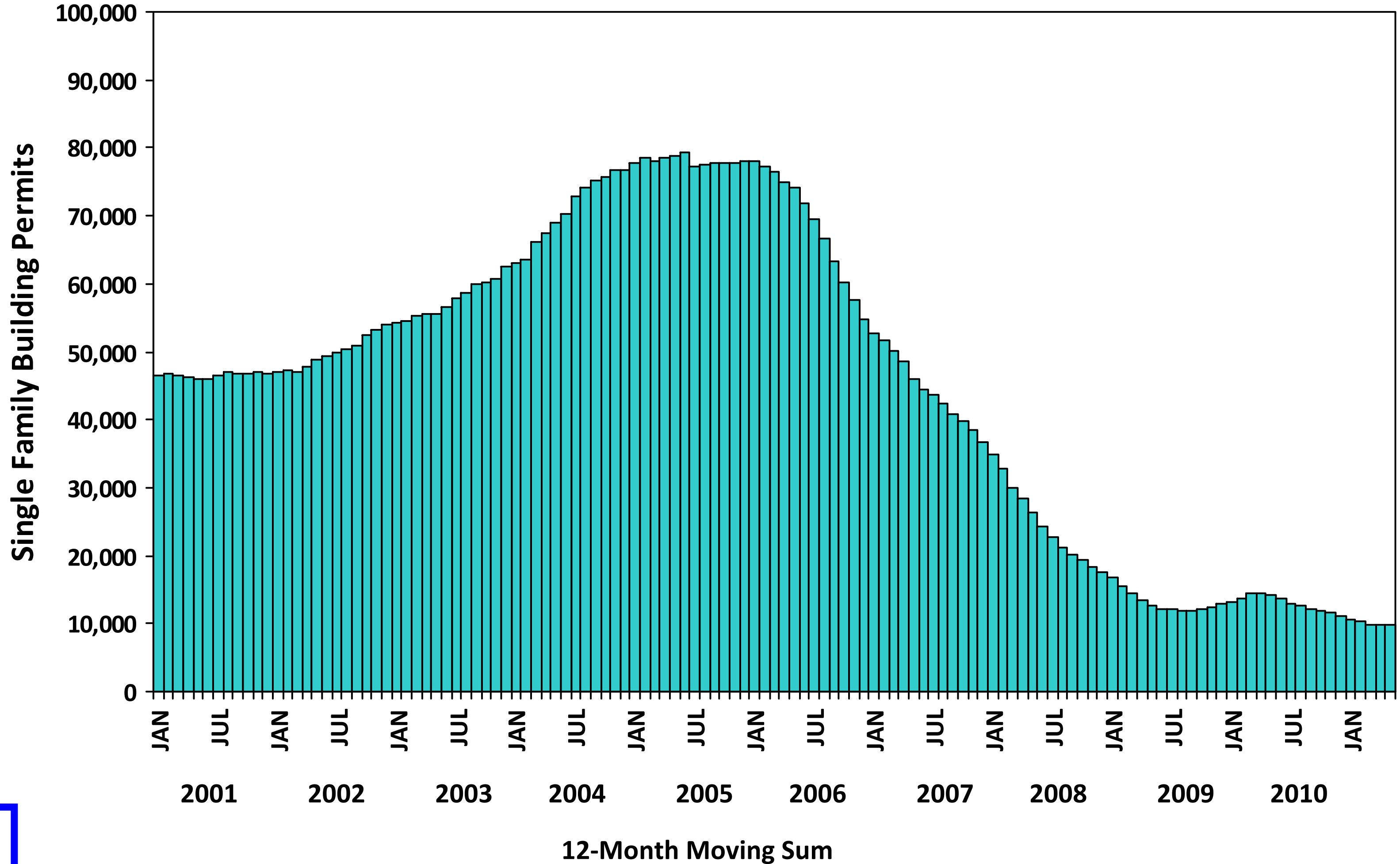
Less Than 10k Single Family Permits Suggest Construction Recovery Not Imminent

- 40K to 50K Annual Permits Would Reflect Healthy Economy



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Faster Than Expected Growth Will Significantly Lower FY ’11 Shortfall

- As revised in April, the FY 2011 budget had an unresolved shortfall of $(332) million. The enacted April budget envisioned using FY ’12 revenues to pay off that shortfall.
- The unexpected FY ’11 revenues, however, appear likely to eliminate at least $300 million of the FY 2011 shortfall.
  - Exact ending balance will depend on year-end adjustments which will not be known for several weeks

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Magnitude of FY ’12 Balance Depends on Numerous Factors
- Originally Budgeted at $14 M

- Since most of the $332 M of FY ’12 revenues will no longer be needed for paying off the FY ’11 shortfall, those monies will be freed up.

- While these funds will add to FY ’12 resources, the ultimate magnitude of the FY ’12 ending balance will depend on a multitude of factors.

With the Higher FY ’11 Base, FY ’12 Revenues May Exceed Budget

- April budget assumed FY ’12 base revenues would grow by 5.7% to $7.83 B.
- With higher than expected FY ’11 base, this level could be achieved with 1.8% growth rate in FY ’12.
- Revenue growth rate will be re-evaluated at FAC meeting in October.

Several Factors Could Result In Unbudgeted FY ’12 Costs

- Federal budget negotiations may lead to reduction in state aid – some discussion of increasing States’ share of Medicaid costs by $100 B over 10 years nationwide
- The federal government has yet to approve all $480 M in AHCCCS waiver savings
- State is subject to numerous “budget” lawsuits – such as the freeze in the Medicaid childless adult coverage
- IRS requires State to use operating surplus above 5% to pay off “operating” issuances early.
  - Represents a requirement of the State using tax-exempt financing for the $1.5 B sale-leaseback and lottery bond issuances.
  - Calculation is complex and final requirement is not known until ADOA releases an annual report on the subject each December.

Higher FY ’11 Revenues Help Budget Picture, But Long Term Challenges Remain

- As of last April, the projections of long-term revenue growth and active funding formula requirements resulted in a FY ’14 budget shortfall of $(600) million with the expiration of the 1-cent sales tax
- While the higher than expected FY ’11 revenues would bring the State closer to a balanced budget in FY ’14, it does not create a structural surplus.
- These estimates assumed the continuation of existing funding formula suspensions, which otherwise would add $800 million in permanent spending, including:
  - $300 M in annual K-12 operating suspensions
  - $400 M in annual SFB capital suspensions

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