General Fund Revenues Have Grown Rapidly in the Last 2 Years

- 20% FY '06 Growth
  - Sales Tax = 16.7%
  - Individual Income Tax = 24.1%
  - Corporate Income Tax = 24.6%
- 2-Year growth for '05 and '06 of almost 40% greatest in at least 35 years.
General Fund Revenue
Rapidly Approaching $10 Billion
-- only $6.2 Billion in FY 2003

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How Much of Gain is Permanent?

• Maybe 50%? While revenues increased by 20% in FY 2006, Personal Income may have grown 10%.
• While 50% of the recent gain may be temporary, it may not be one-time.
• Examples of recurring one-time gains include the stock market, real estate, business profits, and employee compensation (stock options).

Capital Gains Alert: expect $200 B in national distributions this year – up from $130 B in ’05 and $14 B in ’03.
Growth in 1st Trimester of FY 2007 Is Down From Last Year, But Still Double-Digit

- July-October revenues are 11% above last year.
- Sales tax is up over 10%.
- Individual income tax is up over 11%, although it is unclear how much of this increase was aided by ’06 “hang-over” – some payments reflect ’05 liabilities.
- Corporate income tax is up almost 23%.
Where Do We Go From Here?
- Arizona Blue Chip ’07 Forecast
Remains Near Historical Averages

<table>
<thead>
<tr>
<th>Calendar Year</th>
<th>Personal Income</th>
<th>10 yr Avg = 7.3%</th>
<th>Retail Sales</th>
<th>10 yr Avg = 6.8%</th>
<th>Job Growth</th>
<th>10 yr Avg = 3.4%</th>
</tr>
</thead>
<tbody>
<tr>
<td>2005</td>
<td>9.3%</td>
<td></td>
<td>13.2%</td>
<td></td>
<td>5.3%</td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td>8.4%</td>
<td></td>
<td>8.1%</td>
<td></td>
<td>4.6%</td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td>7.4%</td>
<td></td>
<td>6.8%</td>
<td></td>
<td>3.7%</td>
<td></td>
</tr>
</tbody>
</table>

JLBC
How Does JLBC Forecast Revenues?
-- A Consensus Process with 4 Inputs

Sales and income tax forecast equally weights:

- FAC average
- UofA model - base
- UofA model - low
- JLBC staff forecast
- Remaining revenues (5% of total) are staff forecast

JLBC
25%

UA - Low
25%

UA - Base
25%

FAC
Consensus
25%
FY2008 “Big 3” Forecast Growth by Input

- UA Models More Cautious Than Other 2 Inputs,
- Low UA Model Includes A Recession Scenario
- Excludes Impact of 5% Income Tax Reduction in FY 2008

The above percentages represent the weighted average of each participant’s September forecasts for the Big 3 categories.
Evaluating the Odds of Flat Revenue Growth - How Does that Compare to the Odds of a Recession?

• National Blue Chip places the odds of a recession at 25% in the next 12 months
  – Based on responses from 55 panelists
  – 10 most optimistic place odds at average of 12.0%
  – 10 most pessimistic place odds at average of 38.4%

• Arizona Blue Chip was asked when the next recession would occur in Arizona
  – 13% said prior to 2008
  – 20% said 2008
  – 67% said 2009 or beyond
Spending Trends and Challenges
FY 2007 Will Mark 4th Consecutive Year that Spending Outpaced Population/Inflation

General Fund Expenditures FY 1998 - FY 2007
“TABOR” Differential Depends on Stage in the Economic Cycle

- TABOR Differential is 10 yr. Average of Spending vs. Population/Inflation

Average annual spending growth:
- '92-'01: 6.7%
- '94-'03: 5.0%
- '96-'05: 5.2%
- '98-'07: 7.6%

Average annual pop/inflation growth:
- '92-'01: 5.5%
- '94-'03: 5.2%
- '96-'05: 4.9%
- '98-'07: 5.1%
Funding Formula Spending Has Increased to 67% of the Budget

FY 2007 General Fund Spending

Funding Formulas as a Percent of General Fund
Agency Share of General Fund Over the Last Decade
- School Construction Now Consumes 4% of Budget,
  Otherwise Small Shifts

* FY ’07 includes School Facilities Board spending, which represents 4.3% of FY ’07 General Fund expenditures.
Two-Year Revenue Growth of 39% Turned A Structural Deficit Into A $900 Million Surplus

Structural Surplus (+) / Shortfall (-)

Structural Balance is the Difference in Permanent Revenues and Permanent Spending
Budget Stabilization Fund Reached
The 7% Cap in FY 2006

- $650 M balance in FY ‘06.
- Fund capped at 7% of General Fund.
- $10 M FY ’07 deposit and interest earnings will keep fund at 7%.
Challenges in the Year Ahead
- We Have Already Committed
$380 Million in FY 2008 Budget

- Complete 2-Year 10% Income Tax Cut (’06 Session)  $178
- Corporate Sales Factor (’05 Session)  32
- Consolidated Corporate Returns (’94 Session)  55
- Complete Full Day Kindergarten Phase-In (’06 Session)  80
- Universities Research Facilities Debt Payment (’03 Session)  35
Potential Process Improvements

• Improve state’s financial reports: one report lists the General Fund as $9 billion, while another says $17 billion.

• Review public-private partnerships: is legislative oversight adequate?

• Improve debt reporting.

• Expand actuarial audits: Health Care Group.

• Expand expenditure forecast modeling: TANF.