

FY 2007 – As noted in the table, the FY 2007 consensus forecast remained essentially unchanged between December and March. While there has been some shift between components, the overall weighted average for FY 2007 from the March consensus of 8.3% is only up a tenth of a percentage point from December's 8.2% consensus.

FY 2008 – The FY 2008 consensus forecast declined by 0.5 percentage points, from 4.8% to 4.3%, between December and March. All of the components of the forecast (except for the UA Low, which was already reflecting a recession scenario) were more cautious for FY 2008 in March than they were in December. The FY 2008 General Fund revenue forecast in the JLBC January Baseline was based on the December consensus with minor adjustments for the small revenue categories.

The 4-sector consensus forecast incorporates a variety of opinions. There are two inputs based on econometric models – the UA Low and Base forecasts. Also, there are two inputs based on economists' analysis of current data – the FAC panel survey and the JLBC Staff forecast.

In the March forecast, the UA model results generally represent cautious forecasts, particularly for FY 2008. The UA Low weighted average of 0.4% represents a recession, and the UA Base average of 4.4% is well below historical trend growth of about 7%.

The FAC panel average of 4.8% is a bit more optimistic than the UA averages, but still below the long-term trend growth rate.

While the UA/FAC sectors forecast below average growth, the Arizona Blue Chip Economic Forecast (February 2007) is projecting near-historical growth rates for 2007 and 2008 in Arizona personal income, retail sales, and job growth. The 18 economists on the panel are surveyed monthly by ASU's Carey School of Business. As you know, the Blue Chip panel is a well-established measuring stick of current economic thinking. Since this Blue Chip's moderate growth path is not reflected in the 3 other inputs, the JLBC Staff component has been set at a growth rate of 7.5% to reflect that possible scenario.

FY 2009 and FY 2010 – The FY 2009 consensus continues the cautionary tone of FY 2008, dropping from 4.8% to 4.5% between December and March, while FY 2010 is up slightly, increasing from 6.1% to 6.2%.

RS:ym

Finance Advisory Committee

March 8, 2007

JLBC

Finance Advisory Committee

- The FAC has been advising the Legislature on the Arizona economy for more than 30 years.
- 15 members from both the public and private sectors.
- Committee meets 3 times a year.
- Panelists are polled on revenue forecasts – one of 4 inputs into the consensus forecasting process.

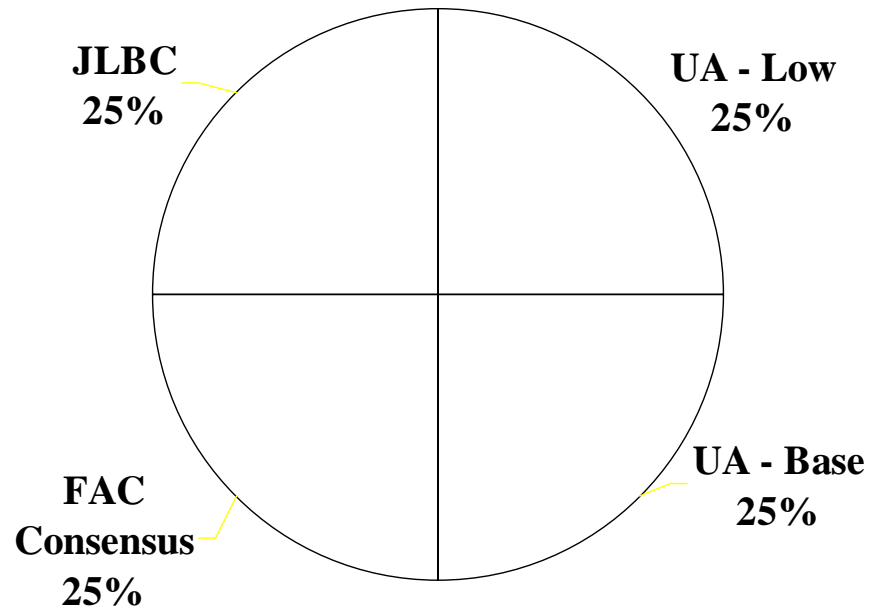
Questions for the Committee

- There are a wide range of forecasts for the next 15 months – ranging from recession to moderate growth – what is your forecast?
- How far will the decline in housing permits ripple through the economy?
- How much has the stock market drop of the last week affected your thinking?

FAC Forecast is a Component of “Big 3” General Fund Revenue Consensus Estimate

Big 3 forecast equally weights:

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



Four-Sector Consensus Process Designed to Incorporate Variety of Opinion and Methodology

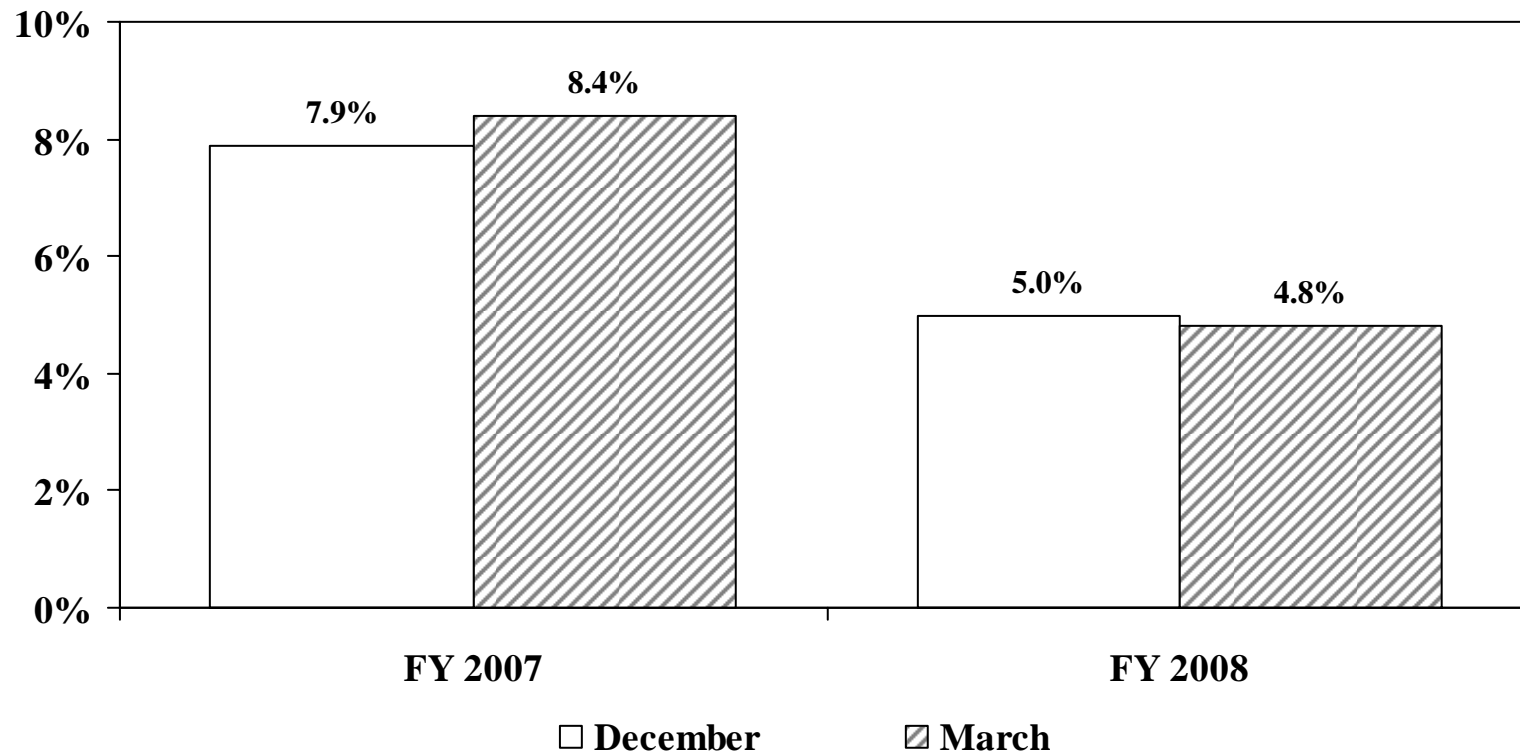
- Level of Modeling
 - 2 inputs based on formal econometric models:
 - UA model consisting of over 200 variables and 100 equations.
 - UA Base and Low forecasts incorporated into 4-sector forecast.
 - 2 inputs based primarily on economists' analysis of current data:
 - Survey of FAC panel members.
 - JLBC Staff forecast.
- Level of Risk
 - Inputs designed to span varying levels of risk – from a 50% probability of meeting or exceeding forecast to 75%-80%.
- Forecast based on pre-tax law basis for comparability – then tax law changes applied to reach final forecast.

What Has Happened Since our December Meeting?

- While November year-to-date revenue collections were 9.3%, February year-to-date collections are 8.3%.
- Revenue growth will continue to decline in FY '07 as effects of enacted tax law changes take effect:
 - 5% individual income tax reduction and corporate sales factor.
- January retail sales tax collections (reflecting the December holiday period) grew by only 1%.
- Estimated individual income tax payments for the December-January period were up by 8.1% over the prior year.

FAC More Optimistic About FY 2007, but More Cautious About FY 2008

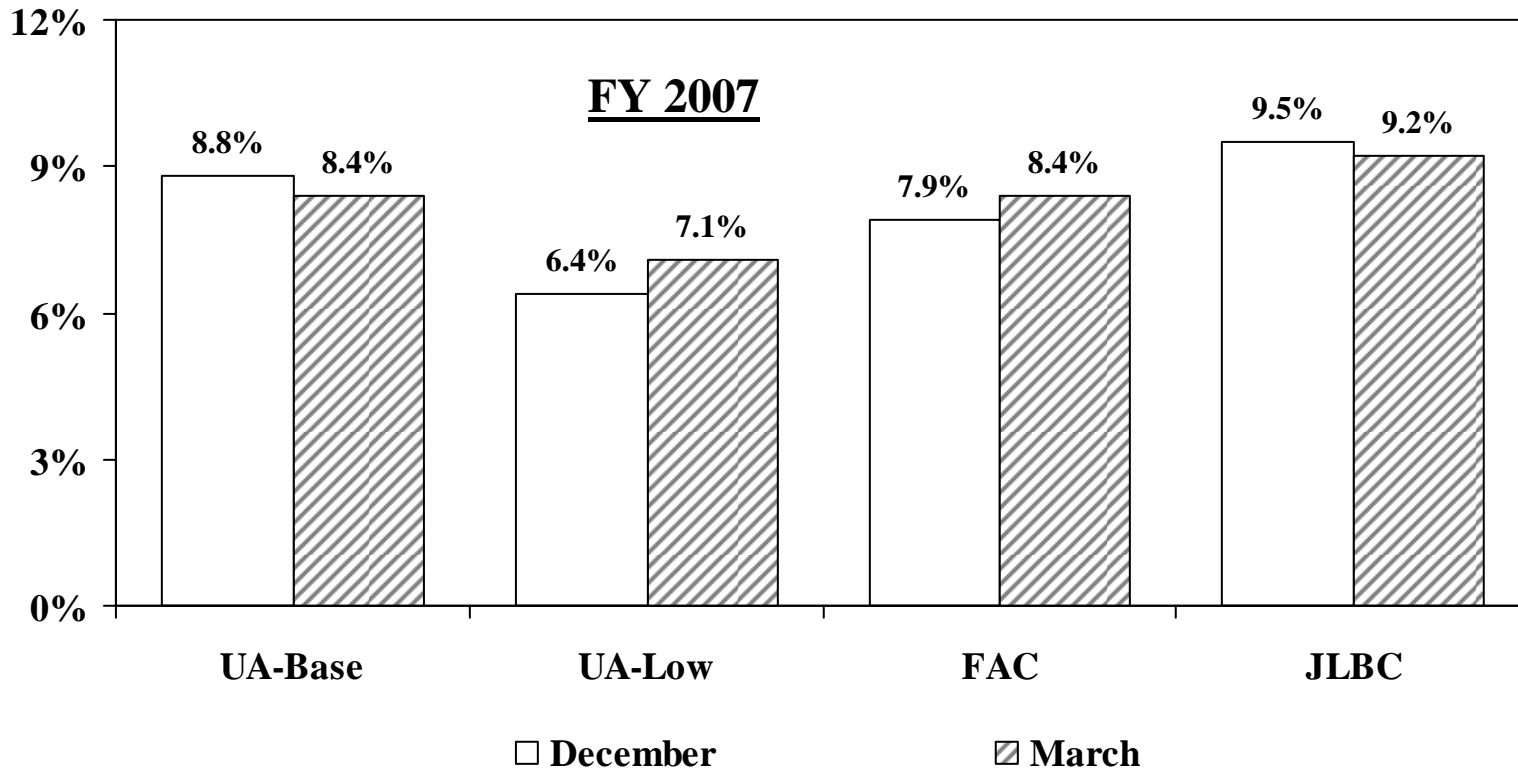
- March Panel Forecast Compared to December



**Weighted Big 3 Average
Prior to Tax Law Changes**

March 4-Sector Consensus Forecast for FY 2007 Compared to December

- Weighted Average Increased Slightly from 8.2% to 8.3%

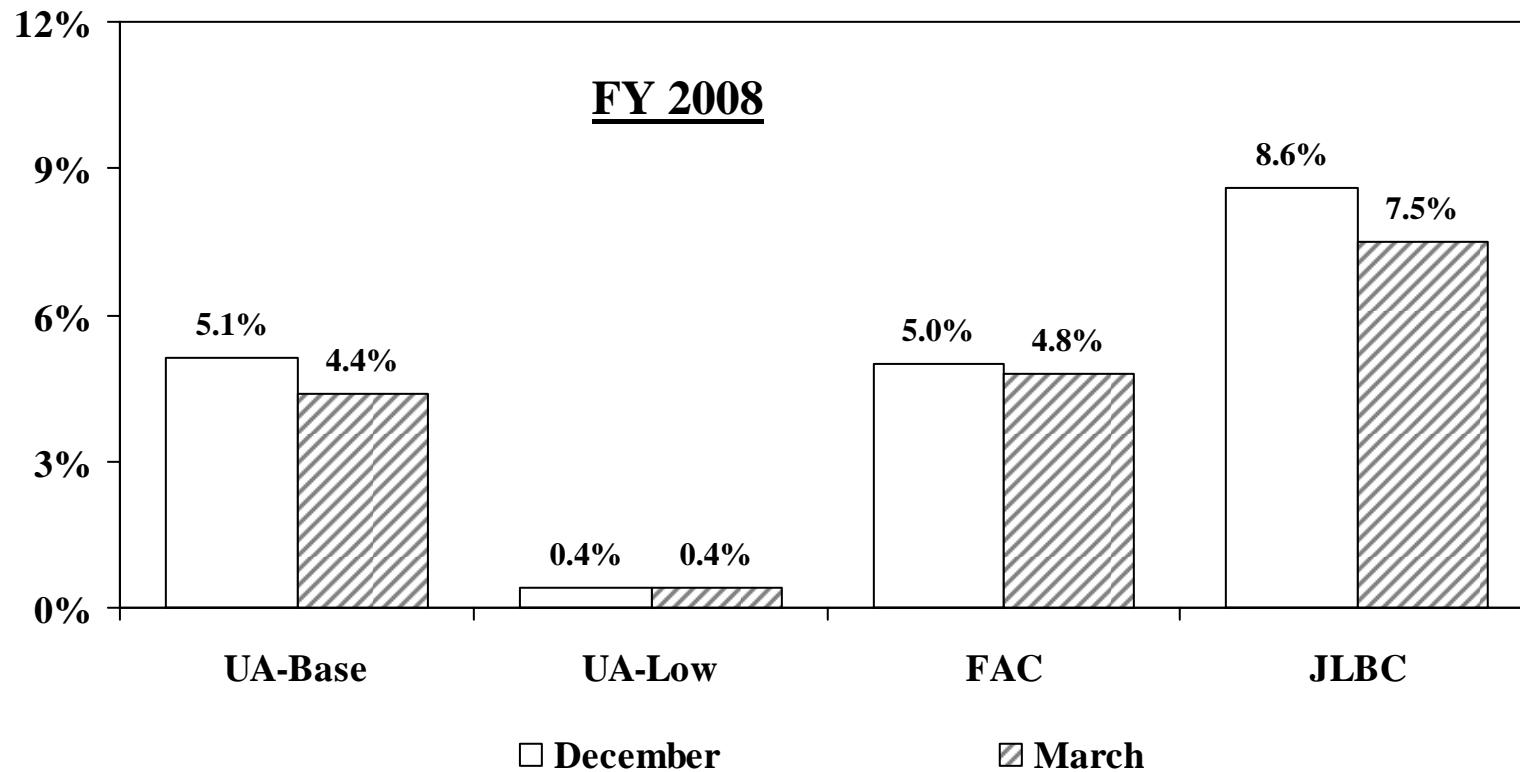


**Weighted Big 3 Average
Prior to Tax Law Changes**



March 4-Sector Turned More Cautious for FY 2008

- Weighted Average Decreased from 4.8% to 4.3%
- Executive Has Decreased from 6.4% to 6.0%



**Weighted Big 3 Average
Prior to Tax Law Changes**

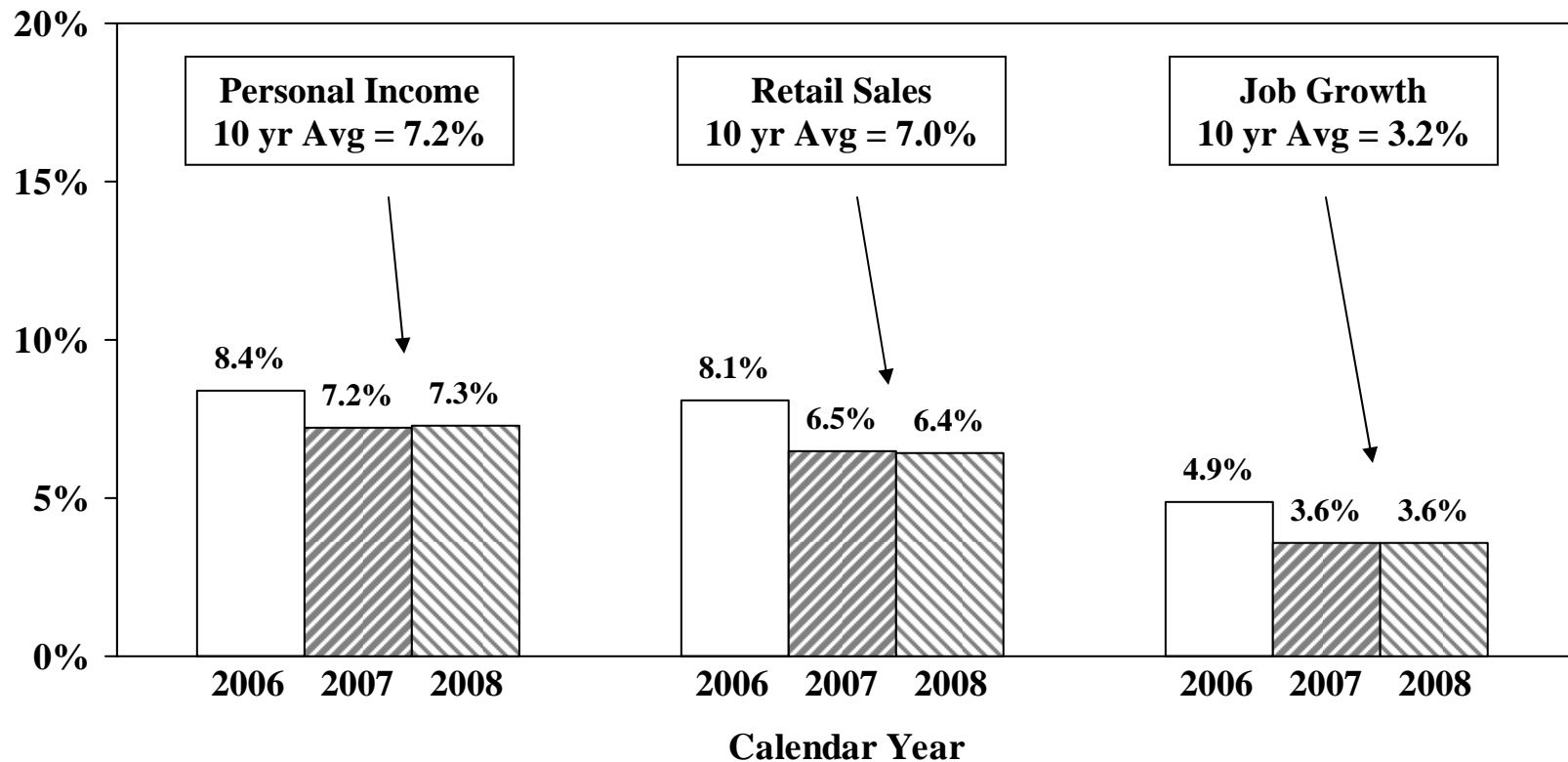


Is 25% Recession Scenario Appropriate?

- UA Low Input at 0.4% Growth is Equivalent to A Recession

- National Blue Chip (January 2007) 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 15%
 - 10 most pessimistic place odds at average of 38%
- Arizona Blue Chip (January 2007) is more optimistic – 16% see next recession by 2008.
 - 8% said prior to 2008
 - 8% said 2008
 - 84% said 2009 or beyond

While UA/FAC Are More Cautious, Blue Chip Continues to Forecast Growth Near Historical Averages



Source: February 2007 Arizona Blue Chip –
monthly survey of 18 economists



The Blue Chip “Moderate Growth” Scenario is Not Reflected in UA/FAC Inputs

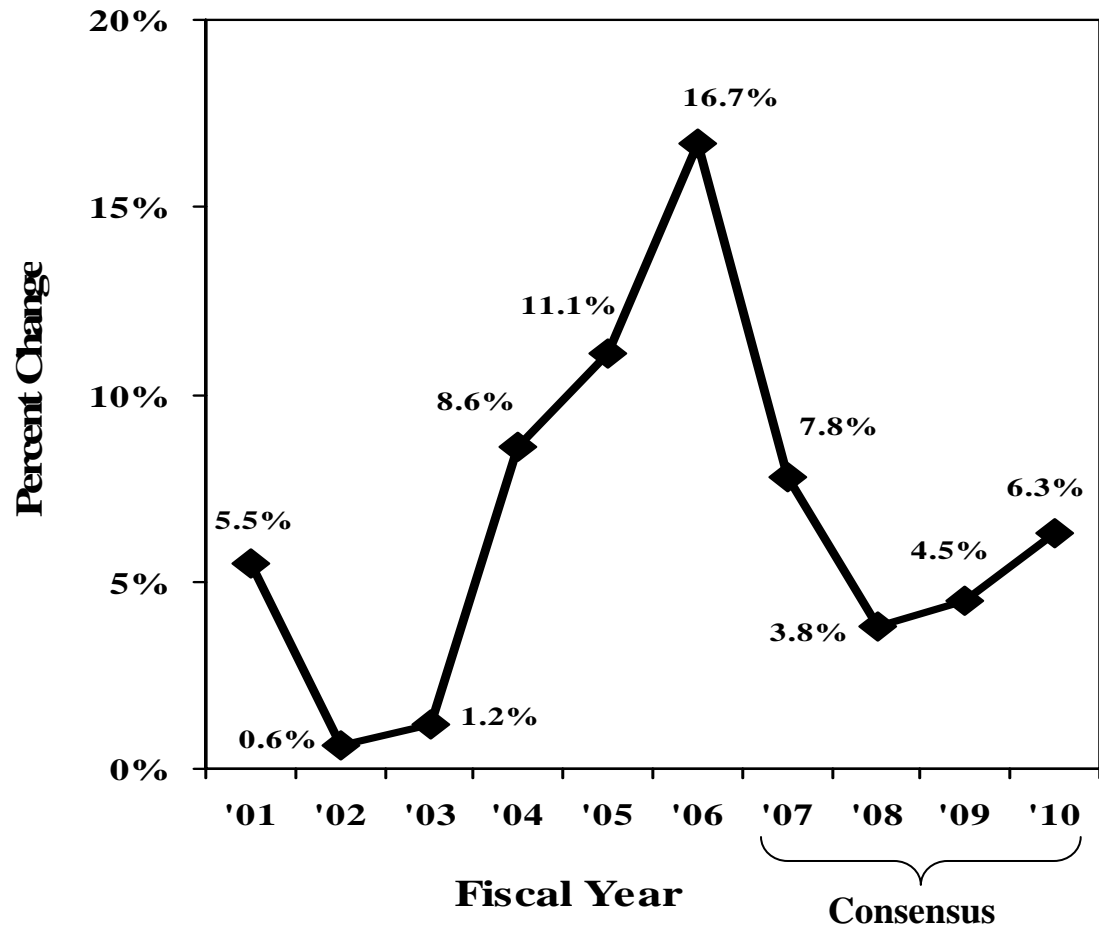
- Historical revenue growth is 7% annually.
- UA/FAC inputs are at least 2% below historical average growth.
- To reflect the Blue Chip scenario near the historical average, JLBC Staff input is set at 7.5% growth.

Sales Tax Growth Rate

Consensus Projects 3.8% for FY 2008

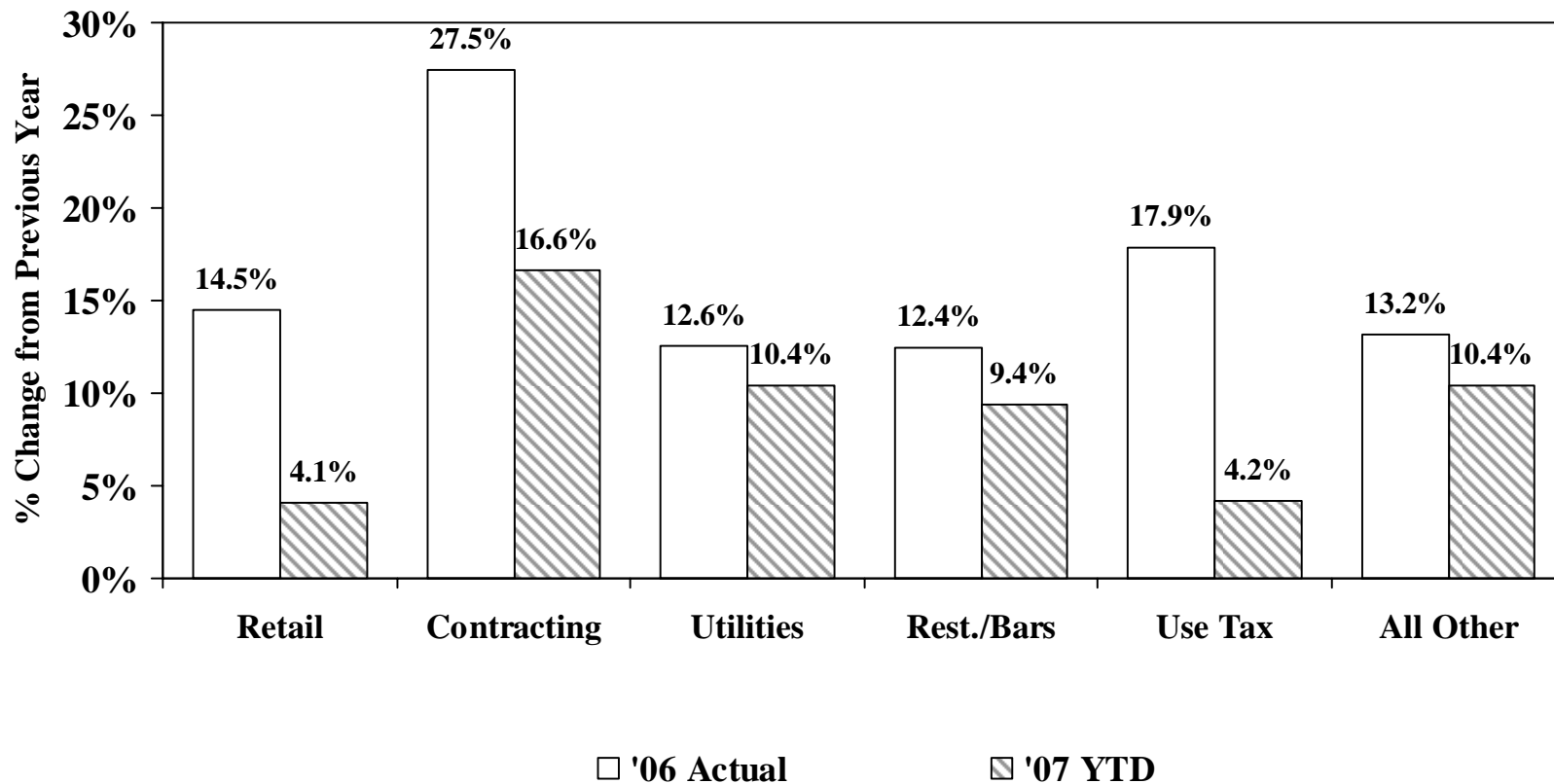
- Executive Projects 7.8%

- '07 YTD rate = 8.2%
- '07 JLBC revised = 8.1%



FY 2007 Sales Tax Collections Have Slowed in All Key Categories

- 1% Growth in Holiday Sales Was Disappointing
- When Will Housing Slowdown Affect Contracting?

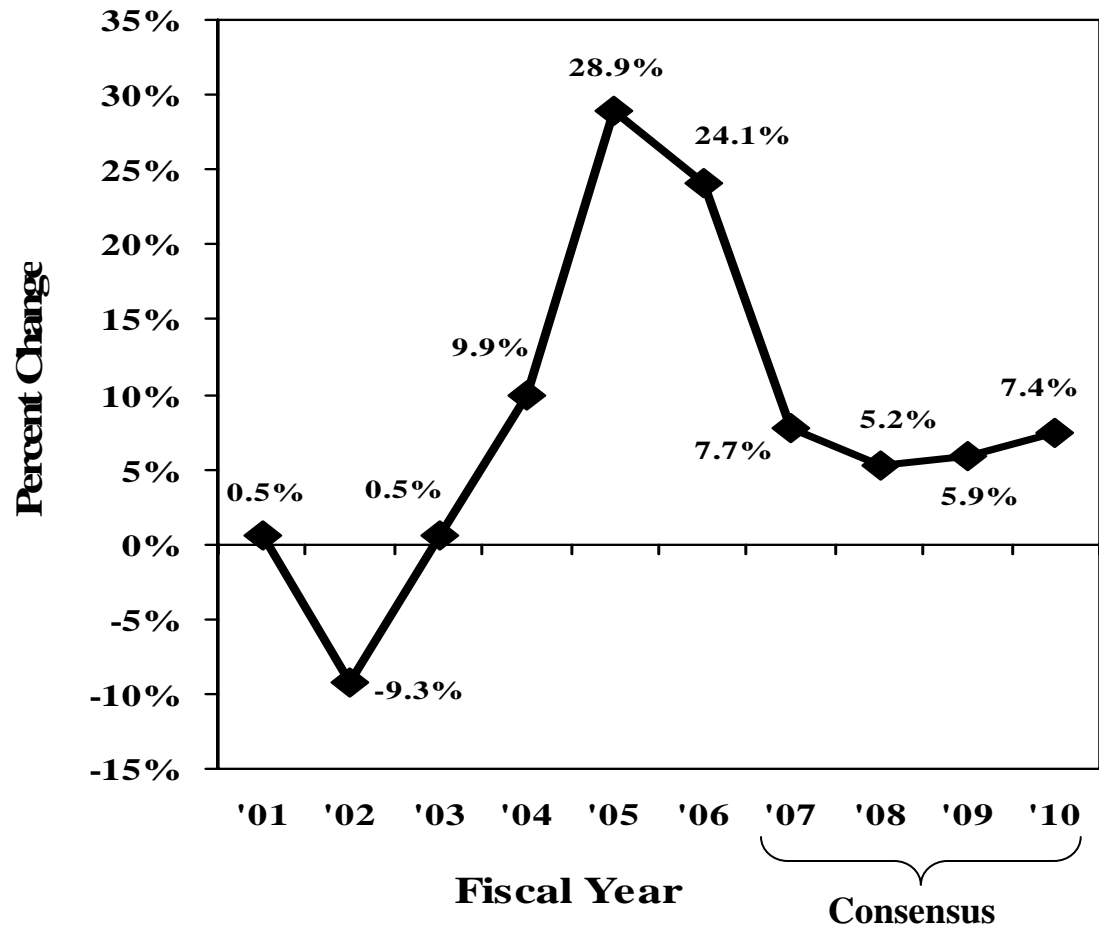


Individual Income Tax Growth Rate

Consensus Projects 5.2% for FY 2008

- Executive Projects 6.7%

- '07 YTD rate = 9.5%
- '07 JLBC revised = 9.3%
 - Adjusting for enacted tax law changes in 2nd half of fiscal year, actual collections are estimated to grow by 4.3% over prior year.



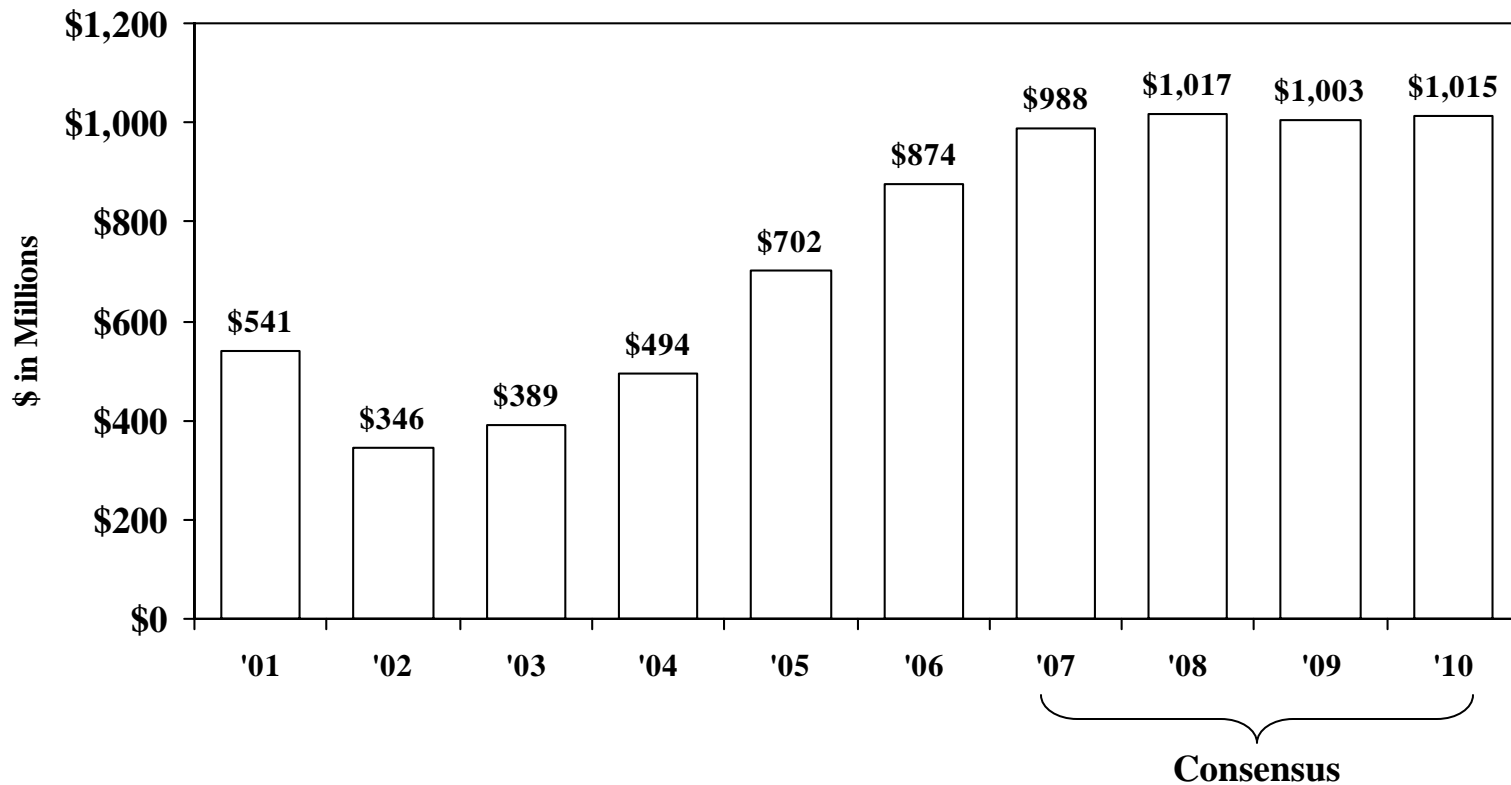
Capital Gains Is An Important But Volatile Tax Revenue Source

- In FY05, capital gains made up 7.5% of Arizona Gross Income compared to 71% for wages.
- However, capital gains contributed more than twice as much -- 16% -- to total net income tax collections.
- Unlike federal rates, there is no lower tax rate for capital gains at the state level.
- Based on CBO projections, it is estimated that the growth rate in capital gains realization will decrease from 38% in FY '05 to (4)% in FY '08, which will decrease capital gains' contribution to net income tax collections.

Corporate Income Tax Collections

Consensus Projects 2.9% for FY 2008

- Executive Projects (0.8)%

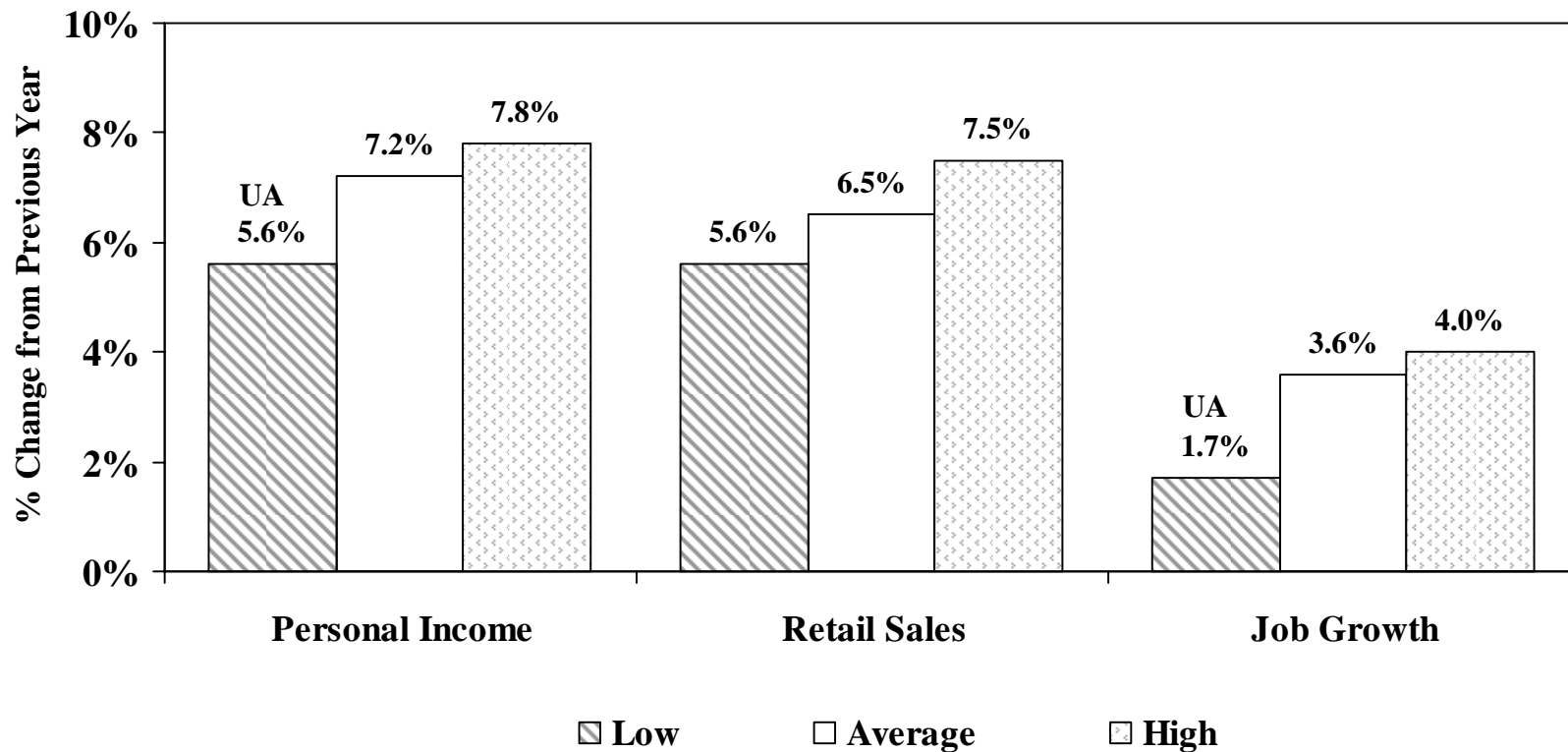


Exceptional Growth in Corporate Profits is Not Expected to Continue

- After growing by 19.1% in 2004 and 12.5% in 2005, U.S. corporate profits increased by an estimated 20.8% in 2006.
- The Global Insight forecasting firm projects corporate profits will grow by 4.6% in 2007 and 6.3% in 2008.
- U.S. Blue Chip Economic Indicators predicts corporate profits will grow by 5.0% in 2007 and by 5.3% in 2008.

Views Vary Widely on Future Economic Growth

- UA Input is Lowest of 18 Blue Chip Panel Members for 2 of 3 Key Categories
- UA Models Represent 50% of 4-Sector Consensus Forecast



2007 Arizona Blue Chip Forecast



FY2007-FY 2010 Quartile Forecast Worksheet

	FY 2007	FY 2008	FY 2009	FY 2010
<u>Sales Tax</u>				
JLBC Forecast (3/1/07)	8.1%	7.1%	5.5%	6.2%
UA - Low (2/07 revision)	7.6%	0.2%	1.9%	5.3%
UA - Base (2/07 revision)	7.8%	2.5%	4.9%	7.2%
FAC (3/8/07 Survey)	7.6%	5.2%	5.6%	6.3%
Average:	7.8%	3.8%	4.5%	6.3%
<u>Individual Income Tax</u>				
JLBC Forecast (3/1/07)	9.3%	7.9%	6.5%	7.0%
UA - Low (2/07 revision) withholding	6.1%	2.6%	4.1%	7.2%
UA - Base (2/07 revision) withholding	7.0%	4.8%	6.7%	8.6%
FAC (3/8/07 Survey)	8.3%	5.5%	6.3%	6.7%
Average:	7.7%	5.2%	5.9%	7.4%
<u>Corporate Income Tax</u>				
JLBC Forecast (3/1/07)	14.5%	7.5%	1.3%	0.2%
UA - Low (2/07 revision)	8.8%	-8.0%	-13.8%	-4.9%
UA - Base (2/07 revision)	16.9%	11.6%	0.6%	2.9%
FAC (3/8/07 Survey)	12.3%	0.5%	6.2%	6.5%
Average:	13.1%	2.9%	-1.4%	1.2%

Consensus Weighted Average:	8.3%	4.3%	4.5%	6.2%
JLBC Weighted Average:	9.2%	7.5%	5.5%	5.9%
UA Low Weighted Average:	7.1%	0.4%	1.4%	5.3%
UA Base Weighted Average:	8.4%	4.4%	5.2%	7.3%
FAC Consensus Weighted Average:	8.4%	4.8%	6.0%	6.5%



Note: All percentages are prior to enacted tax law changes.

“Slower Growth Ahead”

**Prepared for:
Finance Advisory Committee**

Elliott D. Pollack & Company

March 8th, 2007

National Perspective



Negatives

- Slowing housing market.
- Consumer spending slowing.
- Inflation an issue?

Positives

- Employment still positive.
- Businesses lean and mean.
- Increase in exports.

**Weakening economies
are more sensitive to
shocks.**



Examples of Direct Shocks:

- **Unexpected oil price escalation.**
- **Terrorist event (especially to financial or commerce infrastructure).**

Examples of Indirect Shocks:

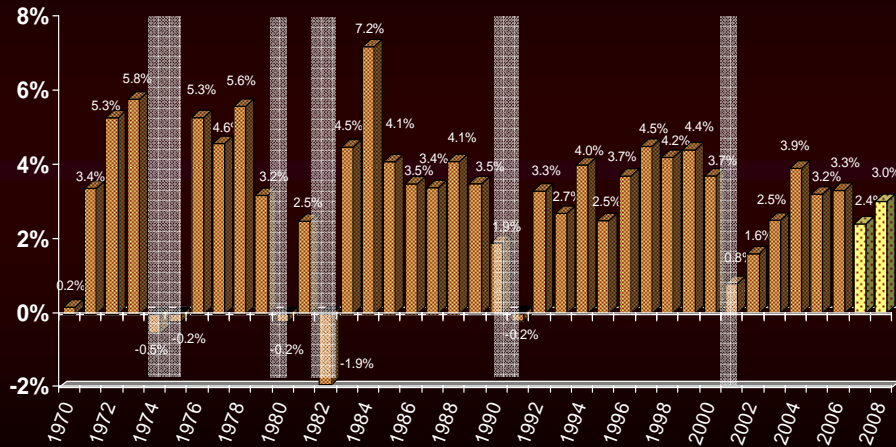
Collapse of housing prices

**What is the
national Blue Chip
panel telling us?**



United States Real Gross Domestic Product* Annual Growth 1970 - 2008**

Source: U.S. Bureau of Economic Analysis & *Blue Chip Economic Indicators*



* Based on chained 2000 dollars.

** 2007 - 2008 are forecasts from the Blue Chip Economic Indicators, February 2007

Recession Periods

ODDS OF A RECESSION

Source: National Blue Chip Panel

January consensus: **25.4%**

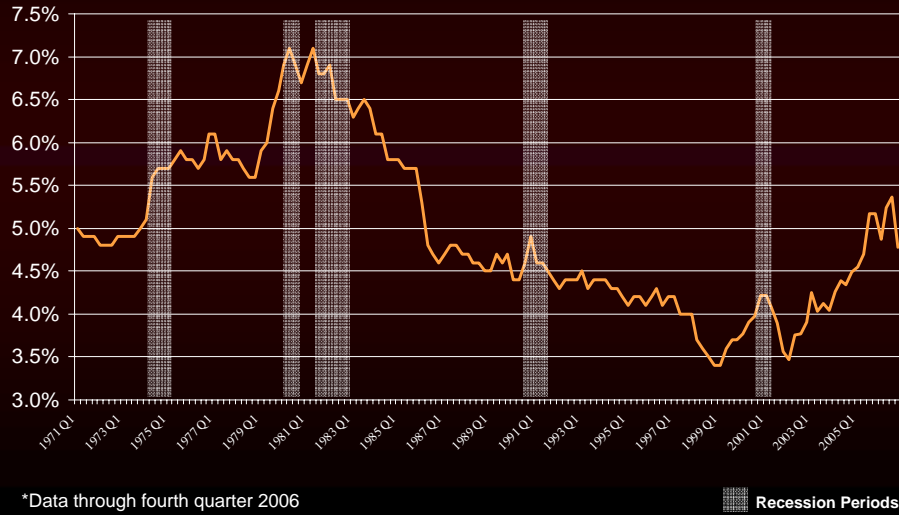
December consensus: **27.4%**

November consensus: **24.8%**

October consensus: **N/A**

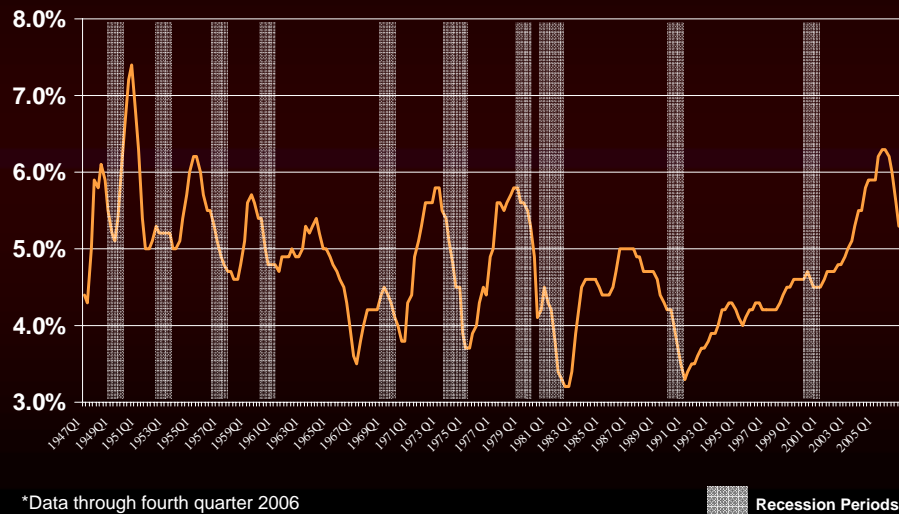
Consumer Energy Goods & Services Spending as a Percent of Personal Income 1971 – 2006*

Source: Bureau of Economic Analysis



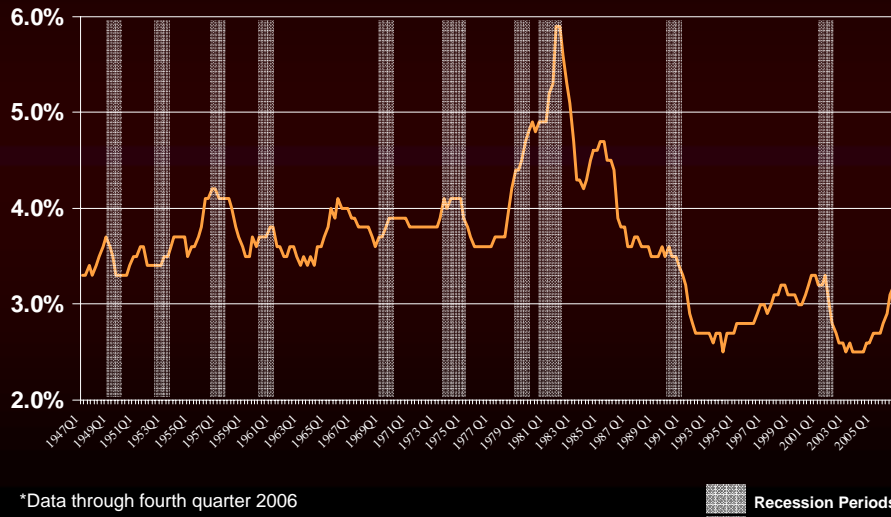
Residential Investment as a Percent of GDP 1947 – 2006*

Source: Bureau of Economic Analysis



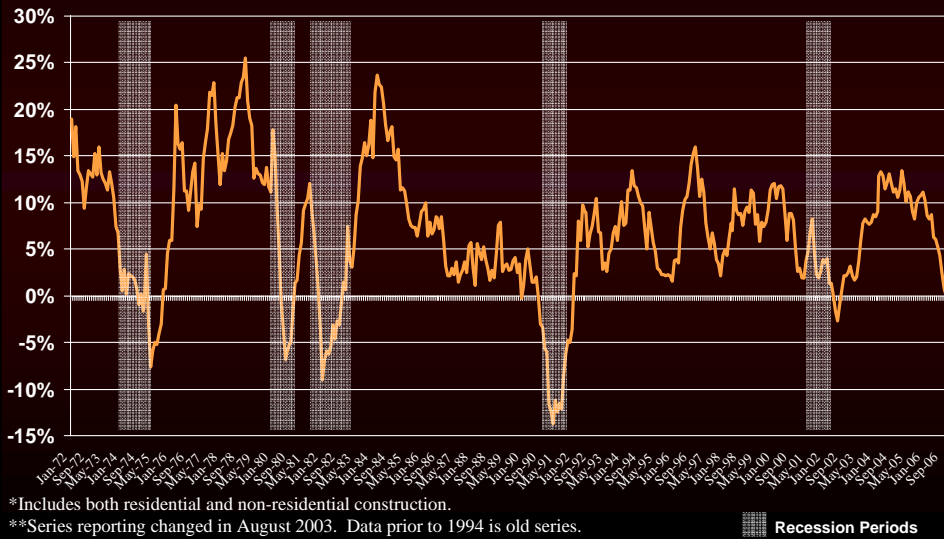
Non-Residential Structures Investment as a Percent of GDP 1947 – 2006*

Source: Bureau of Economic Analysis



Value of Total Construction Put-In-Place* Percent Change Year Ago January 1972 – January 2007

Source: U.S. Census Bureau

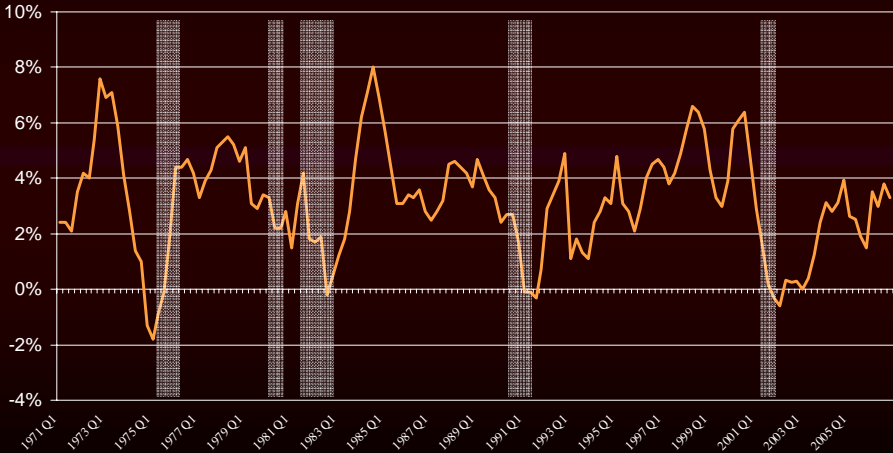


Are people making ends meet?

U.S. Real Personal Income Percent Change Year Ago

1971 – 2006*

Source: Bureau of Economic Analysis

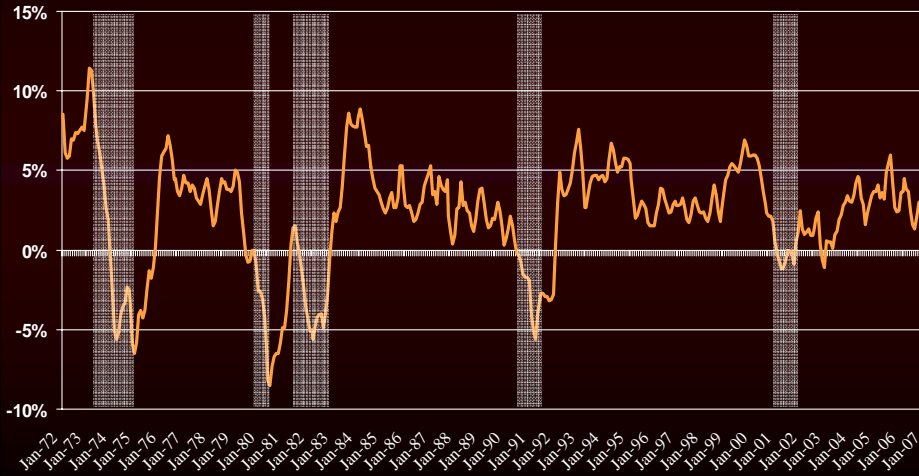


*Data through fourth quarter 2006

Recession Periods

U.S. Real Retail Sales Percent Change Year Ago, 3-Month Moving Average 1972 – 2007*

Source: Federal Reserve Board of St. Louis

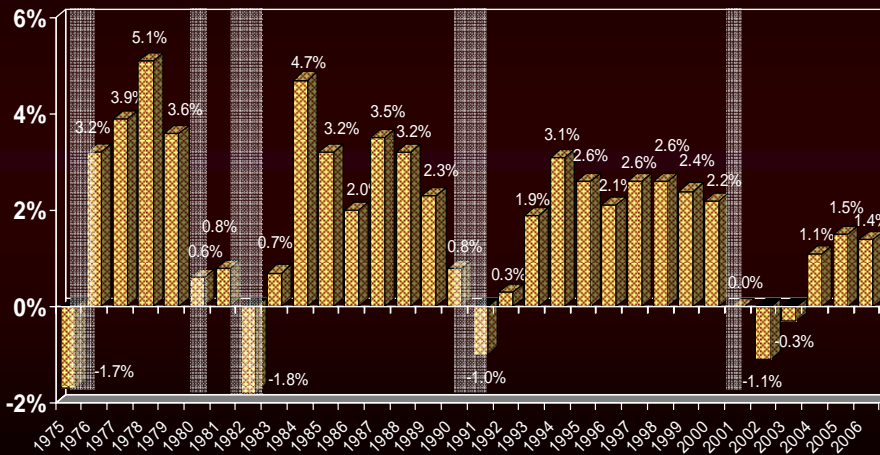


* Data through January 2007

Recession Periods

National Employment* Annual Percent Change 1975–2006*

Source: Bureau of Labor Statistics

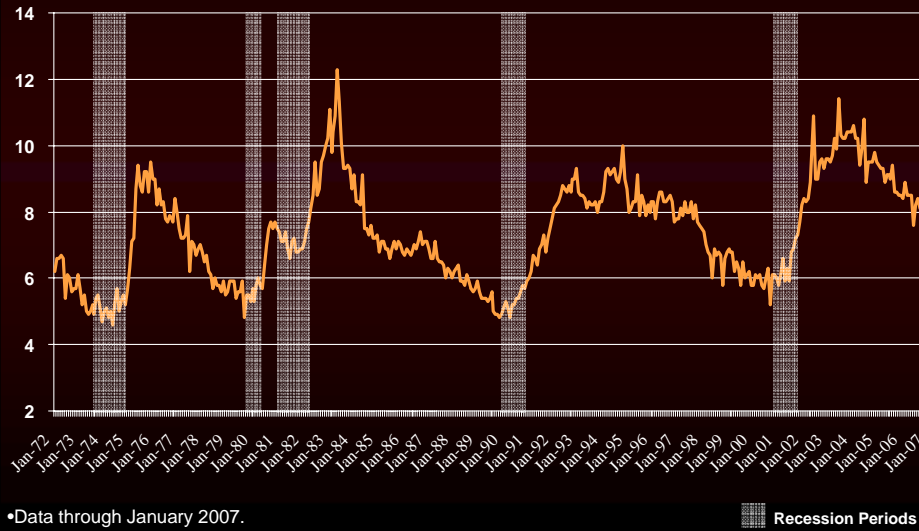


*Non-agricultural wage & salary employment. Changed from SIC to NAICS reporting in 1990.

Recession Periods

Median Weeks Unemployed (S/A) 1972 – 2007*

Source: Bureau of Labor Statistics

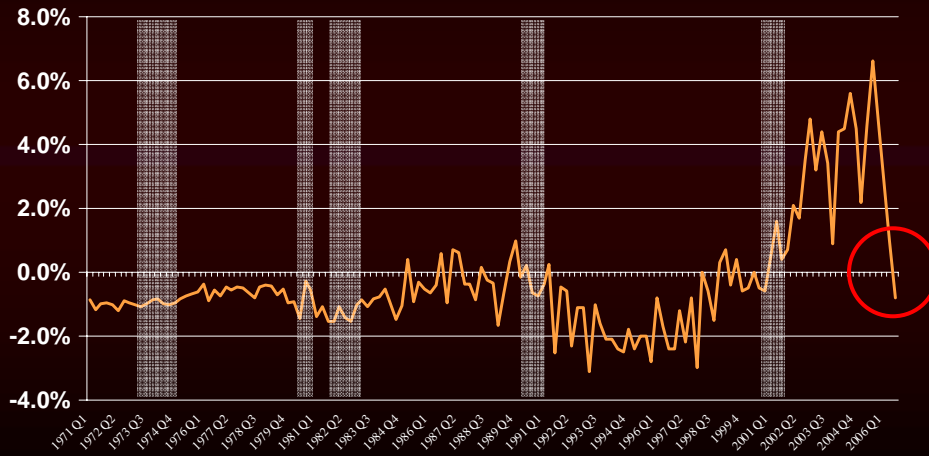


CONSUMER SPENDING Causes of Consumer Caution

- **Reduced home-related spending on home improvement items such as furnishings, appliances, and building materials.**
(Look at completions not starts)
- **Housing-related industries are now cutting jobs.**
- **Slowing growth in household wealth**
- **Mortgage equity withdrawal slowing.**

Mortgage Equity Withdrawal as a share of Disposable Income U.S.: 1971 – 2006*

Source: Bureau of Economic Analysis

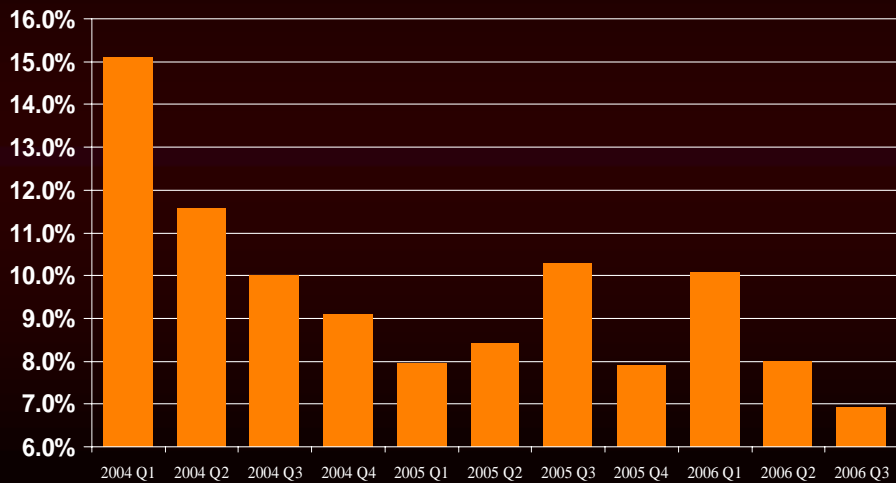


* Data through third quarter 2006

Recession Periods

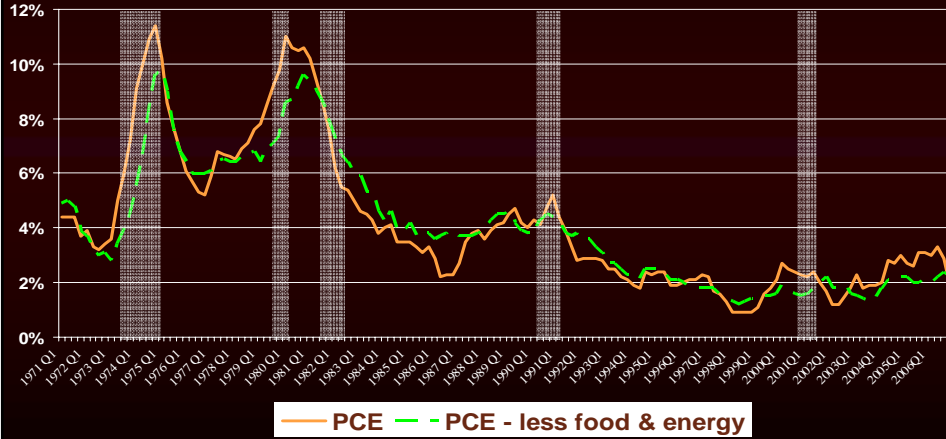
Household Wealth Percent Change Year Ago U.S.: 1971 – 2006*

Source: Federal Reserve Board, Flow of Funds



Personal Consumption Expenditures Price Deflator (2000=100) Percent Change Year Ago 1971 – 2006*

Source: Bureau of Economic Analysis

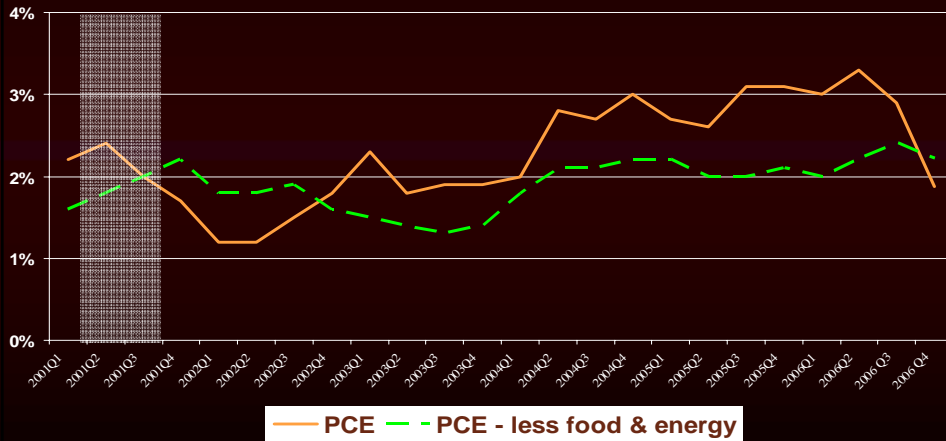


*Data through fourth quarter 2006.

Recession Periods

Personal Consumption Expenditures Price Deflator (2000=100) Percent Change Year Ago 2001 – 2006*

Source: Bureau of Economic Analysis

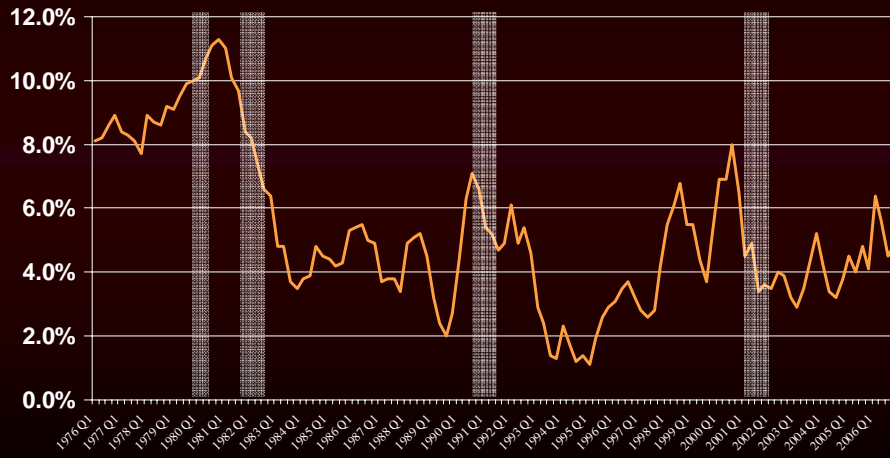


*Data through fourth quarter 2006.

Recession Periods

Compensation per Hour* Percent Change Year Ago 1976 – 2006**

Source: Bureau of Economic Analysis

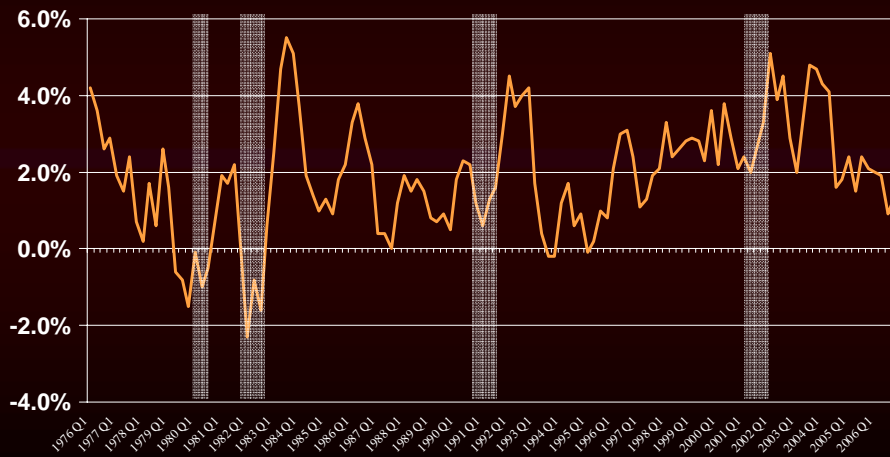


*Non-farm Business
**Data through fourth quarter 2006

Recession Periods

Output per Hour* Percent Change Year Ago 1976 – 2006**

Source: Bureau of Economic Analysis

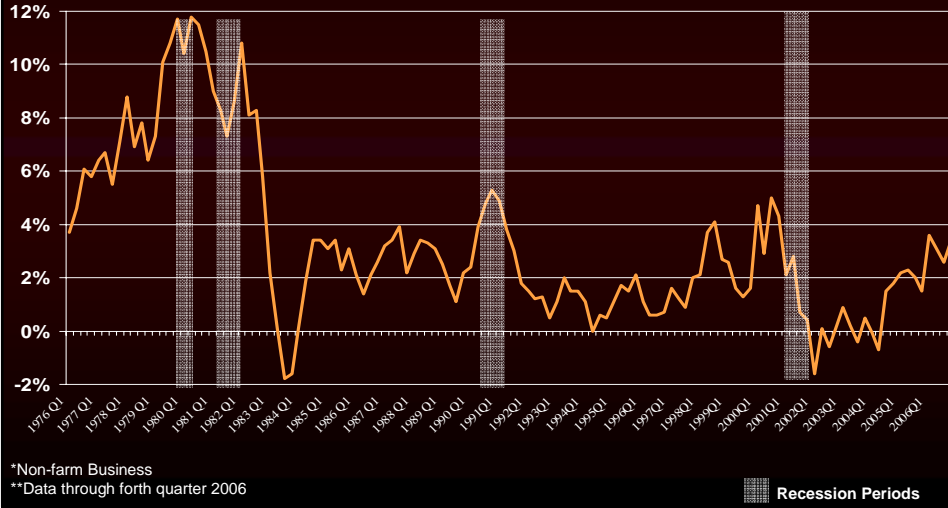


*Non-farm Business
**Data through first quarter 2006

Recession Periods

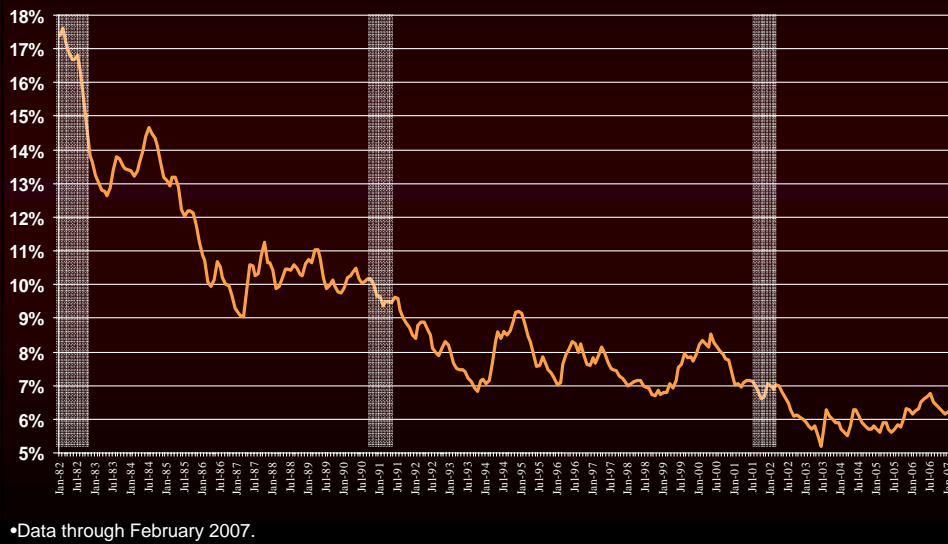
Unit Labor Costs* Percent Change from Year Ago 1976 – 2006**

Source: Bureau of Labor Statistics



30-Year Conventional Mortgage Rates 1982 – 2007*

Source: Federal Reserve Economic Database



3-Month Treasury 1982 – 2007*

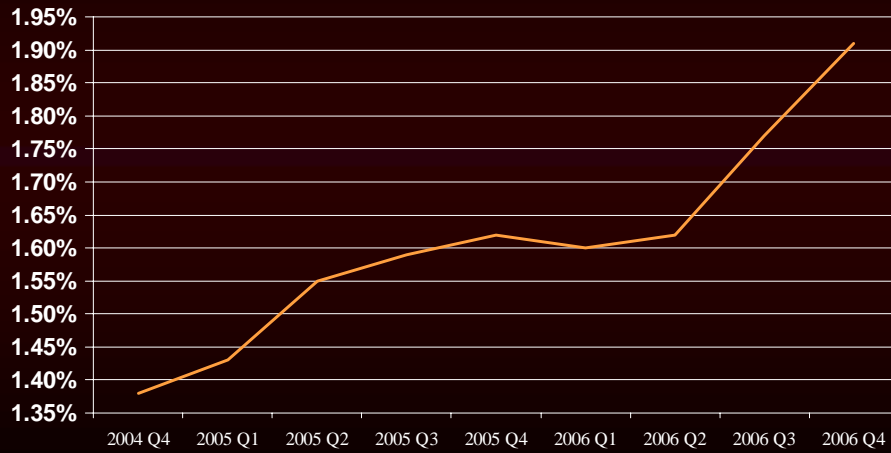
Source: Federal Reserve Economic Database



*Data through February 2007.

Delinquency Rates Single Family Residential Mortgages 2004q4 – 2006q4*

Source: Federal Reserve

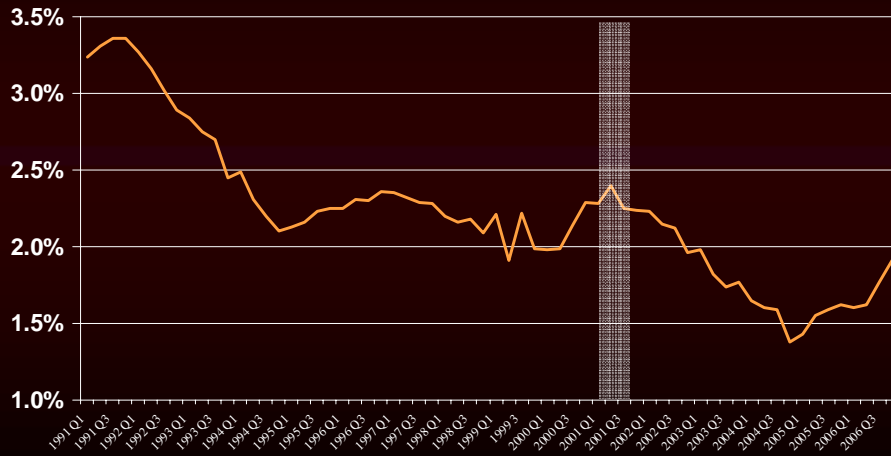


*Data through fourth quarter 2006

Delinquency Rates Single Family Residential Mortgages

1991 - 2006*

Source: Federal Reserve



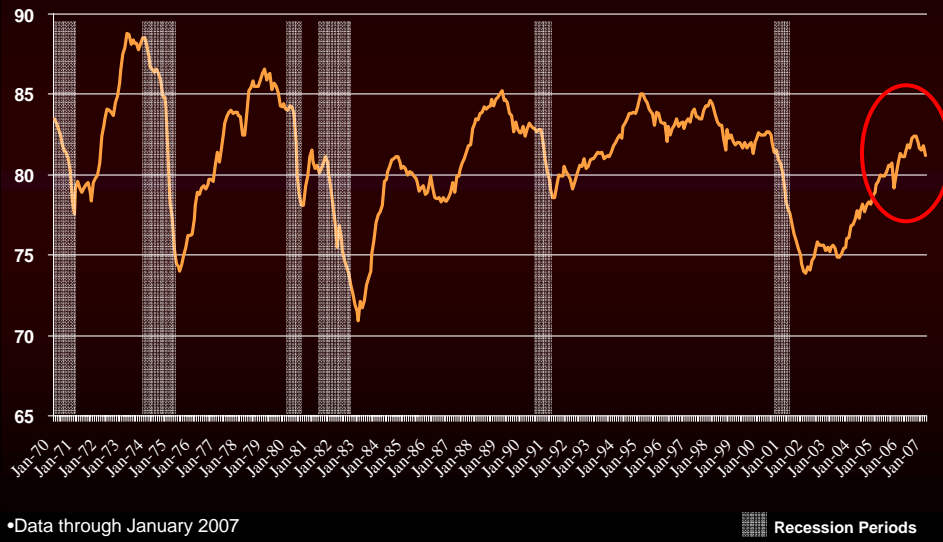
*Data through fourth quarter 2006

Recession Periods

Can business pull us forward?

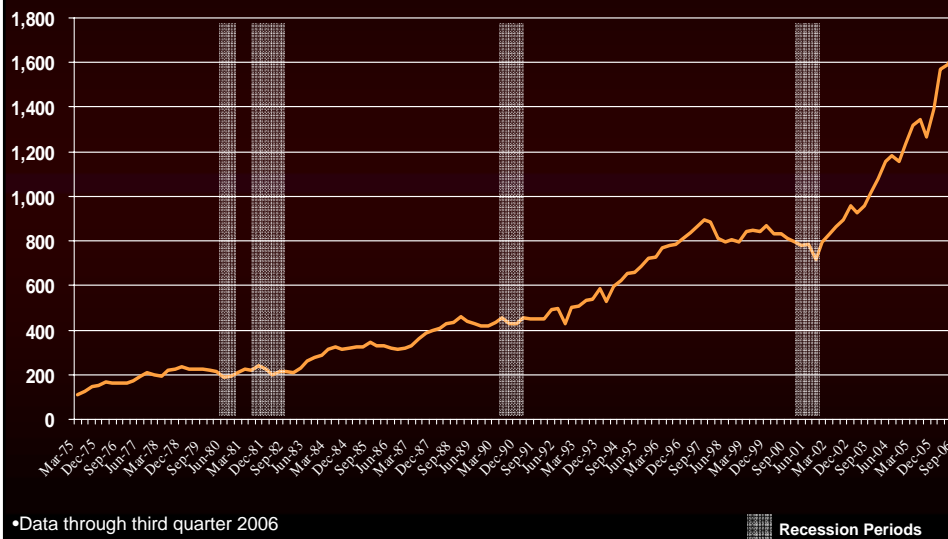
Capacity Utilization Rate 1970 – 2007*

Source: The Conference Board



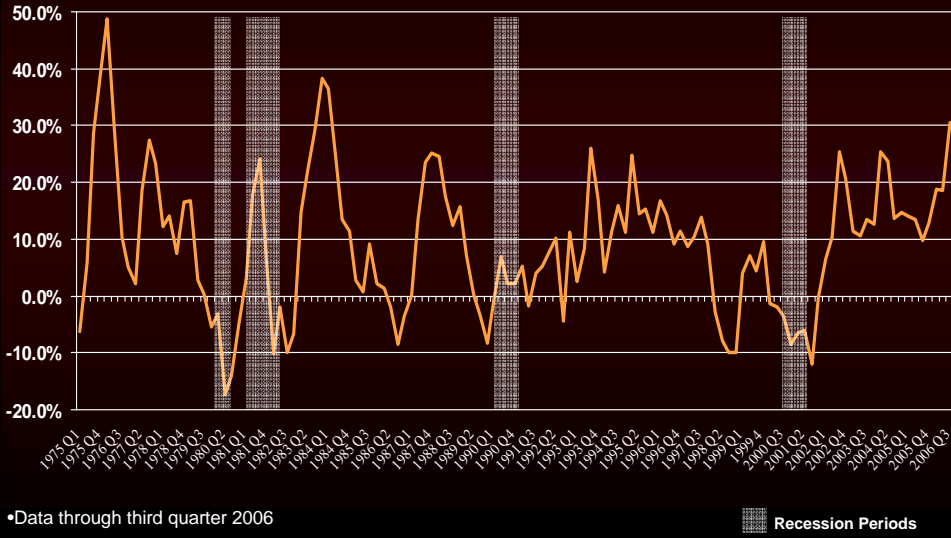
Corporate Profit (Billions of Dollars, SA) 1975-2006*

Source: Freelunch.com



Corporate Profit Percent Change Year Ago 1975-2006*

Source: Freelunch.com



Net Percentage of Large U.S. Banks Reporting Tougher Standards on Business Loans 1991 – 2006*

Source: Federal Reserve, Board of Governors

