

# **Finance Advisory Committee**

## **Briefing Materials**

**December 10, 2007**

**JLBC**

# Finance Advisory Committee

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# **Current Economic Conditions Have Had Widespread Impact on Revenue Collections**

- Through November, collections are down (0.6)%
- General Fund revenues are \$(310) million below forecast
  - Sales tax: (0.2)%.
  - Individual income tax: (1.0)%
  - Corporate income tax: (2.4)%.

## 3 Main Problems

- Housing Market
  - Imbalance in supply and demand.
  - Mortgage financing.
- Inflated Revenue Base
  - Revenues grew 38% in '05 and '06 compared to 19% personal income growth.
- “Wealth effect”
  - Declining housing values affect consumer psyche.

## **2 of 3 Real-Time Indicators Have Dropped This Fiscal Year**

- Retail spending – down (1.7) %.
- Jobs – 45,000 jobs created compared to 135,000 a year ago.
- Withholding – up 6%.

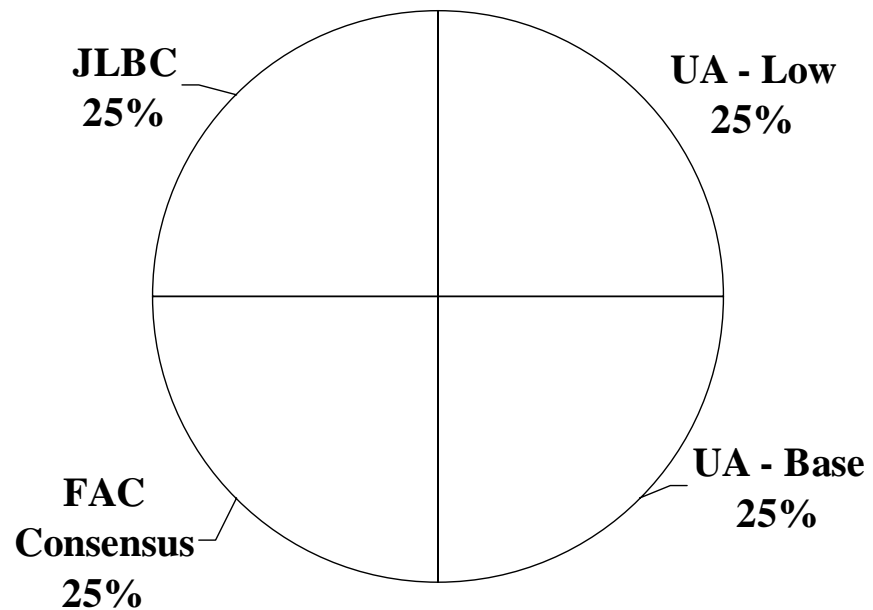
# **Overall Revenue Forecast**

# 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 (4% of total) are staff forecast**

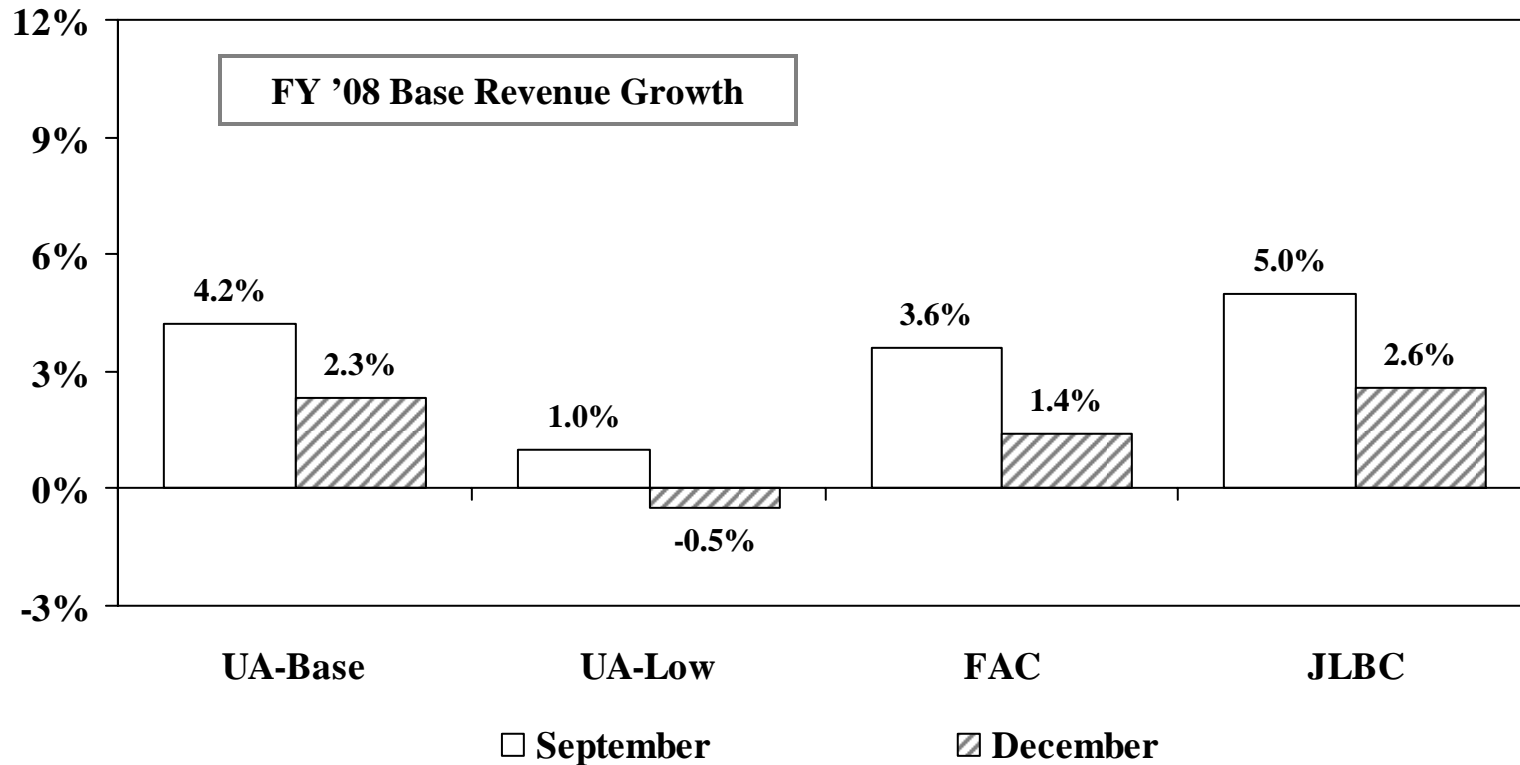


**\* Includes Big 3 categories of sales tax, individual income and corporate income taxes.**



# New FY '08 4-Sector Growth Forecast is 1.5%

- Compares to 3.5% in September and a Budgeted Rate of 8.4%

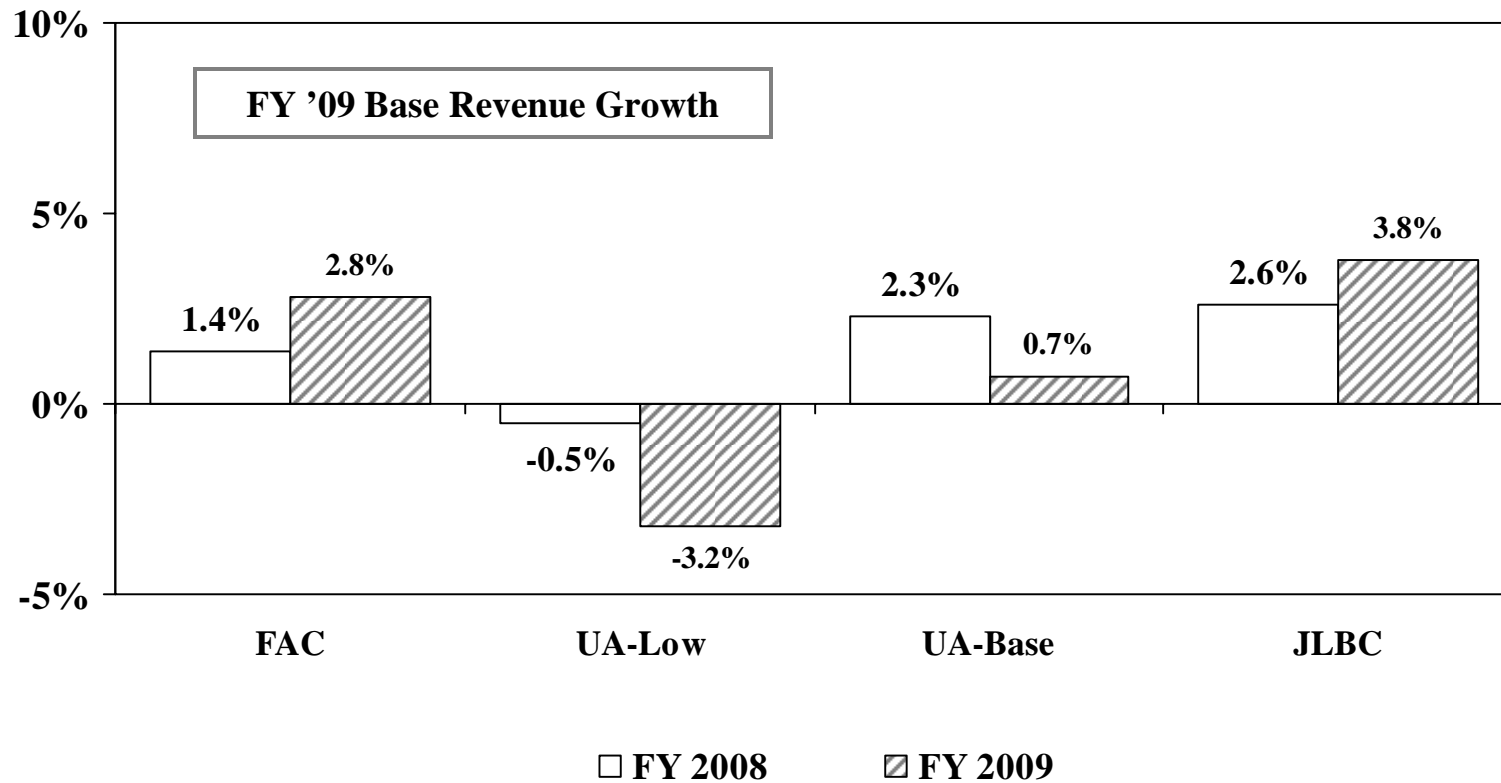


**Weighted Big 3 Average  
Prior to Tax Law Changes**



# New FY '09 4-Sector Growth Drops from 1.5% in '08 to 1.0% in '09

- In September, '09 Growth Was 2.6%

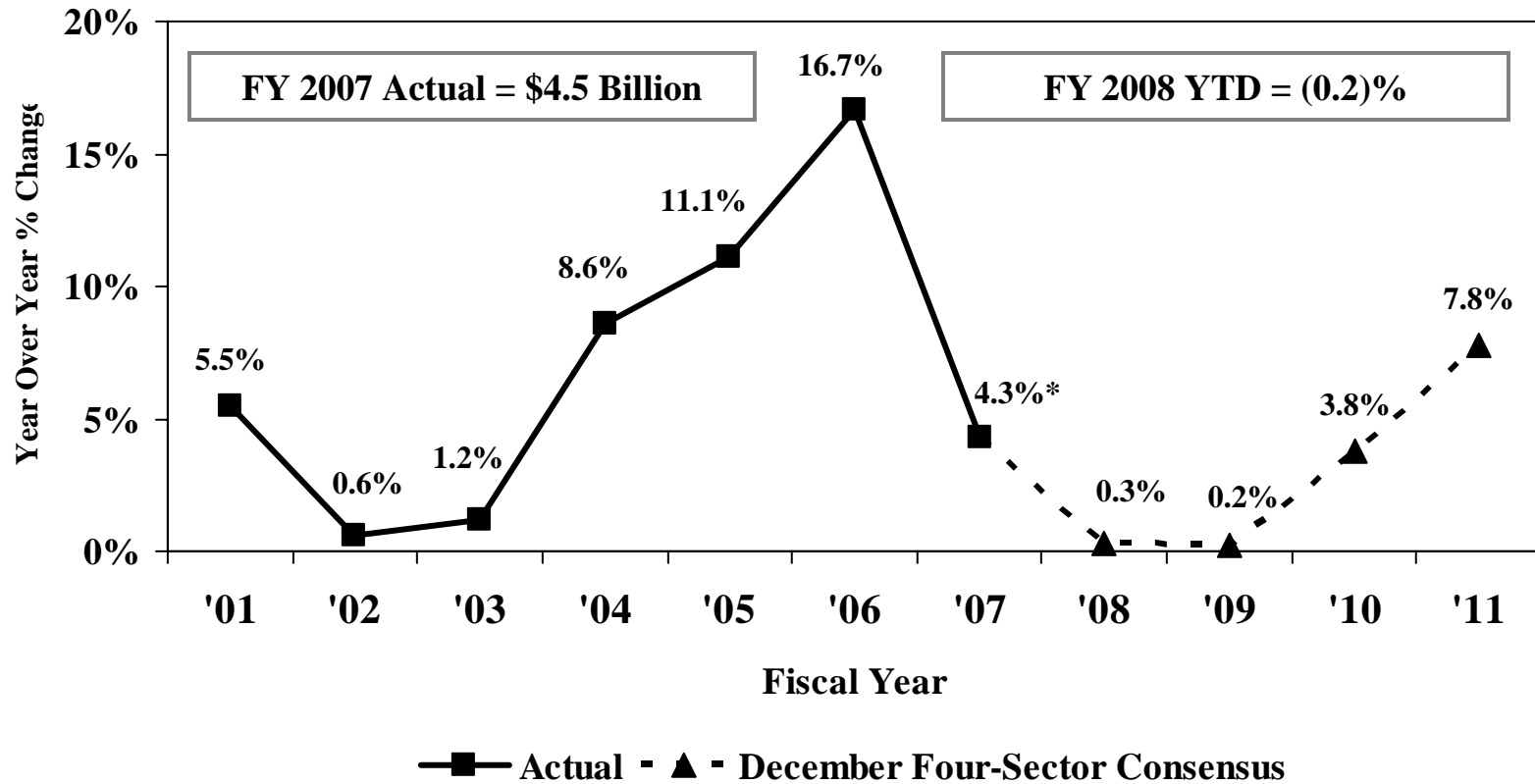


**Weighted Big 3 Average  
Prior to Tax Law Changes**



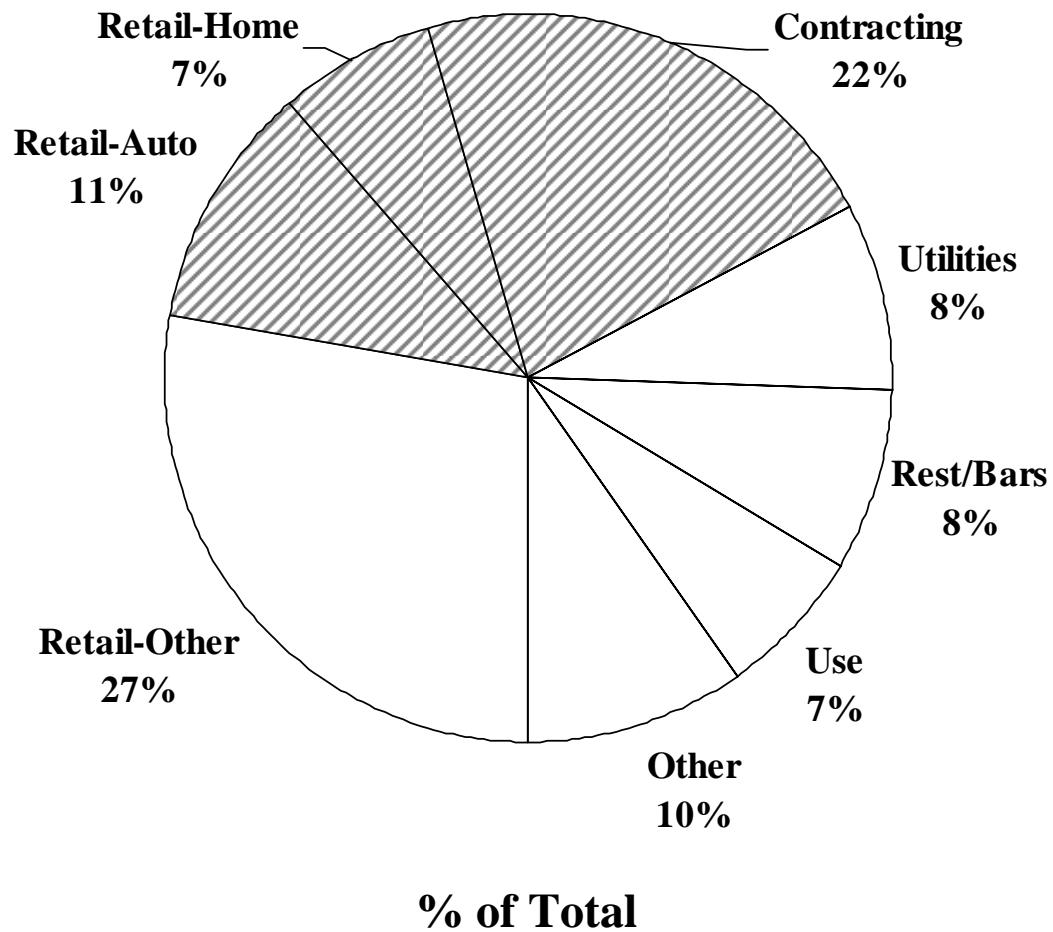
# **Revenue Forecast by Category**

# Sales Tax Growth Flat in '08 and '09

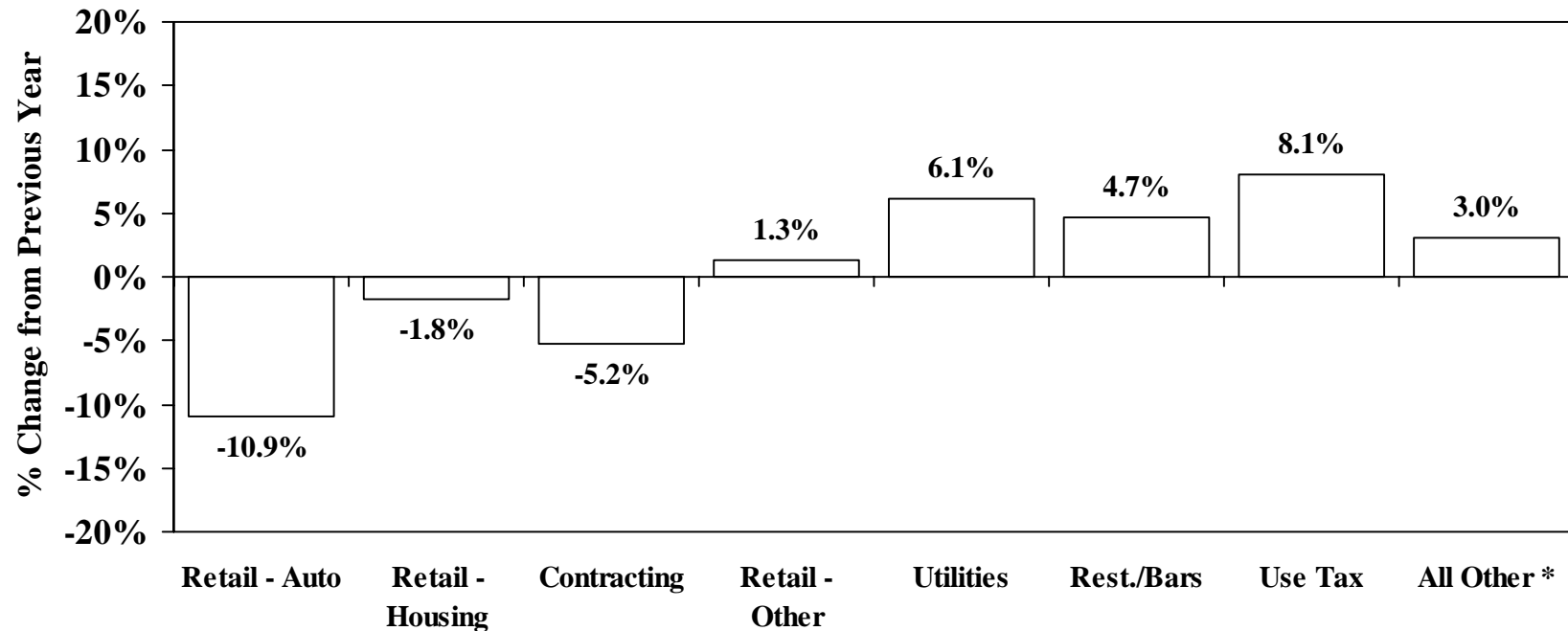


\* 5.6% without the \$(55.2) million estimated payment threshold change.

# Construction and Vehicles Constitute 39% of Sales Tax Collections



# The Decline in Construction and Vehicle Spending Are Offsetting Gains Elsewhere



FY 2008 Year to Date – (Through October)

# **Falling Home Prices Affecting Consumer Spending**

## **The “Wealth Affect”**

- Even if consumers are not selling their homes, declining housing values are thought to reduce their spending habits.
- National studies estimate that consumers reduce spending by 4-9¢ for every \$1 decline in house value.
- With a 10% decline in housing prices, Arizona sales tax would decline \$50 million, or (1)%.

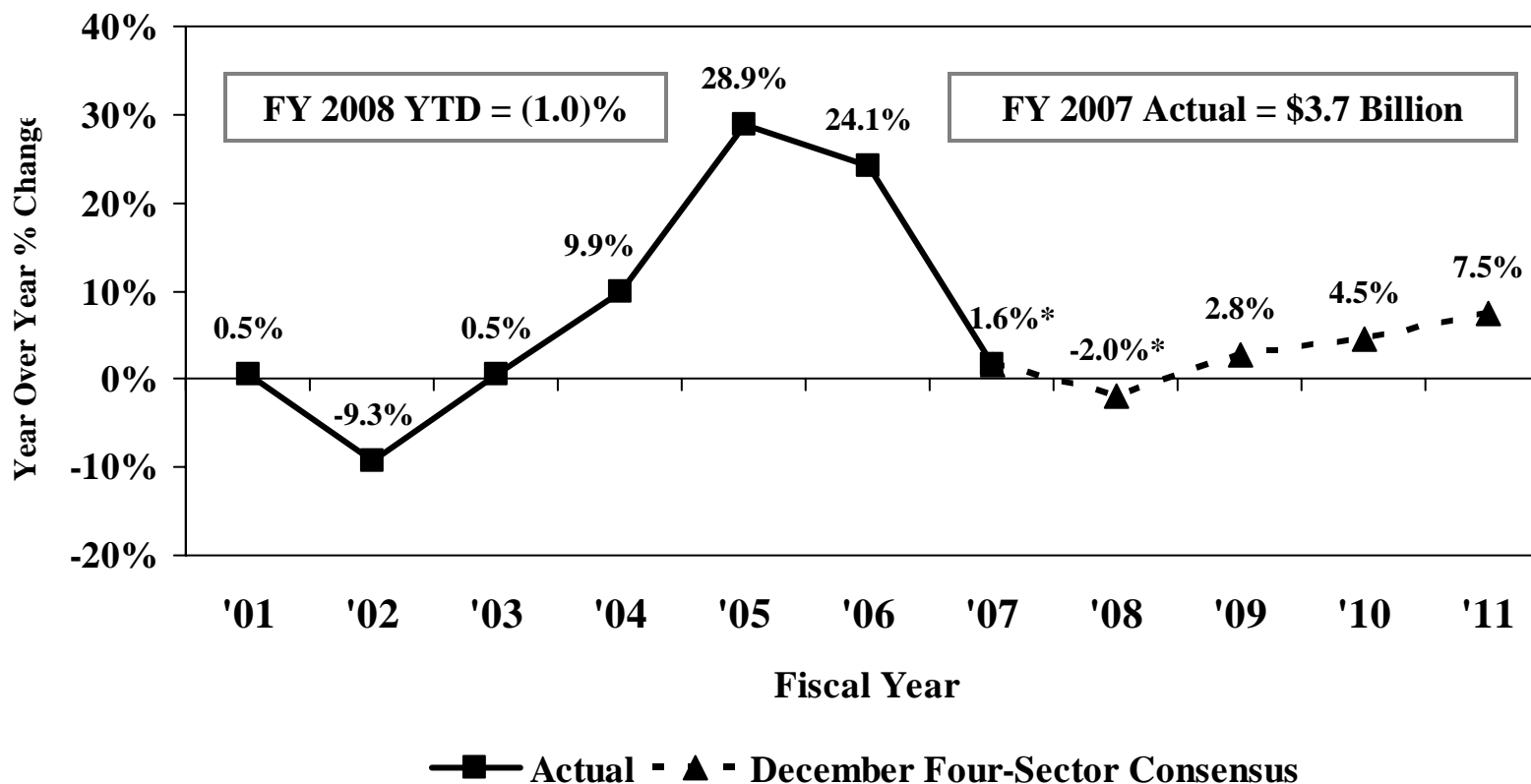
## **Will Mortgage Proposals Help?**

- Proposal only affects 11% of subprime loans.
- For owner occupied homes, the Feds are proposing a 5 year rate freeze and refinancing assistance.
- Arizona has the 3<sup>rd</sup> highest rate of subprime loans, including 132,000 subprime ARMS.
- Feds' mortgage relief plan could affect an estimated 6,500 – 54,000 owner-occupied homes in the state.



# Individual Income Tax Forecast

- Falls (2.0)% in '08 With A Slow '09 Recovery



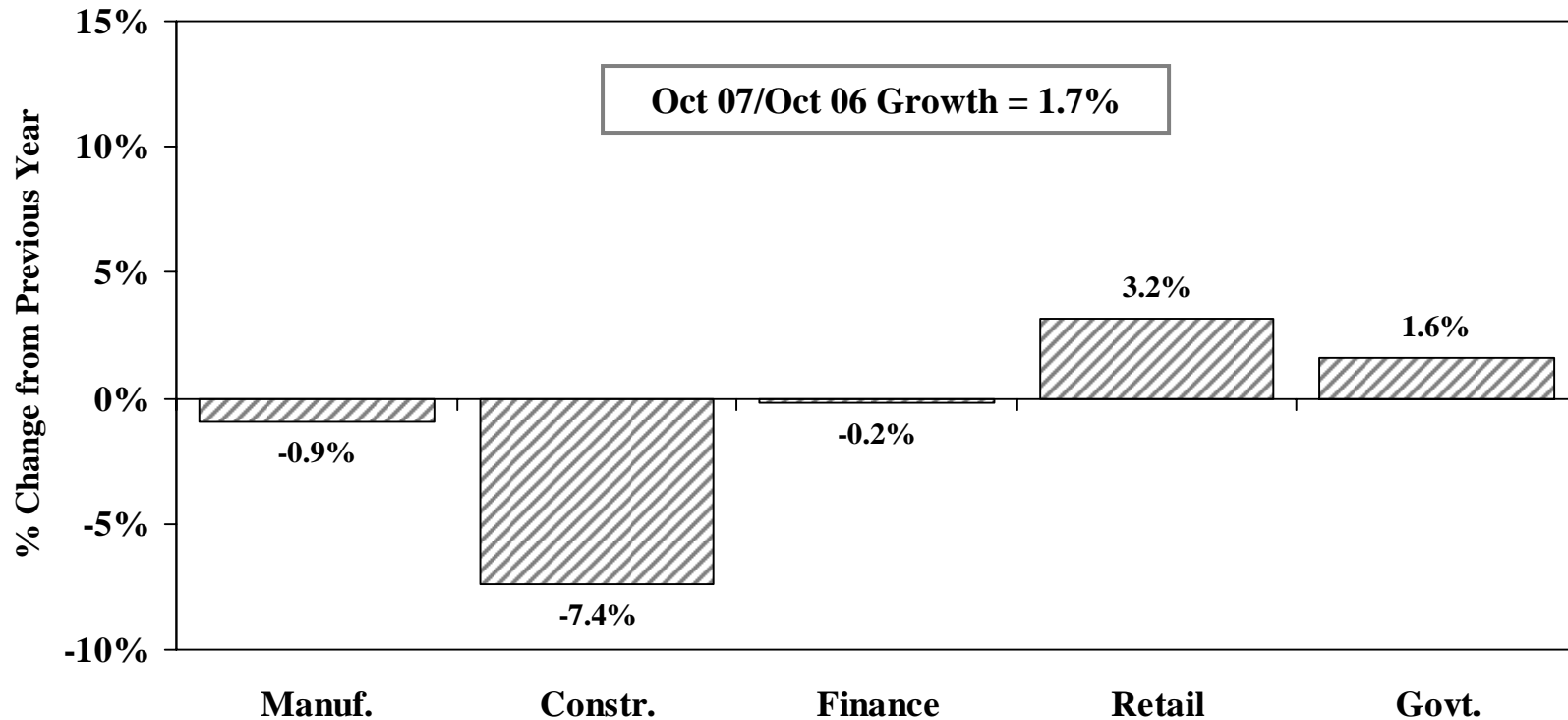
\* Includes reduction for tax law changes.

# **Individual Income Tax 5-Month Collections Down (1.0)%**

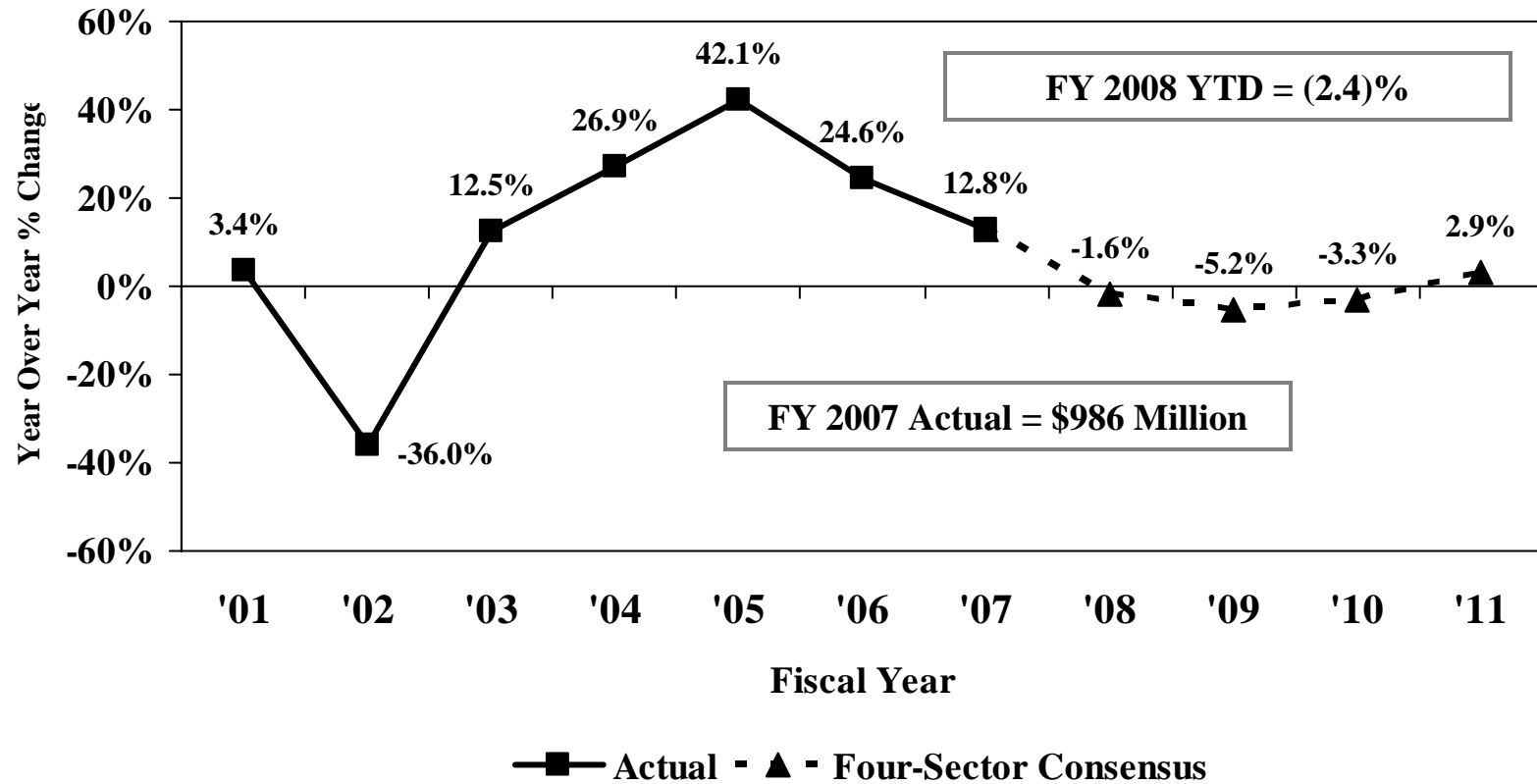
- Refunds have increased over 60%
  - May be “hangover” effect – April extensions resulted in refunds paid out in last 2 months.
- Final payments are down (2)% YTD.
- Positive sign: withholding has maintained 6% growth for the first 5 months.

# Job Losses May Moderate Further Withholding Growth

- Construction Sector Has Experienced Largest Job Loss



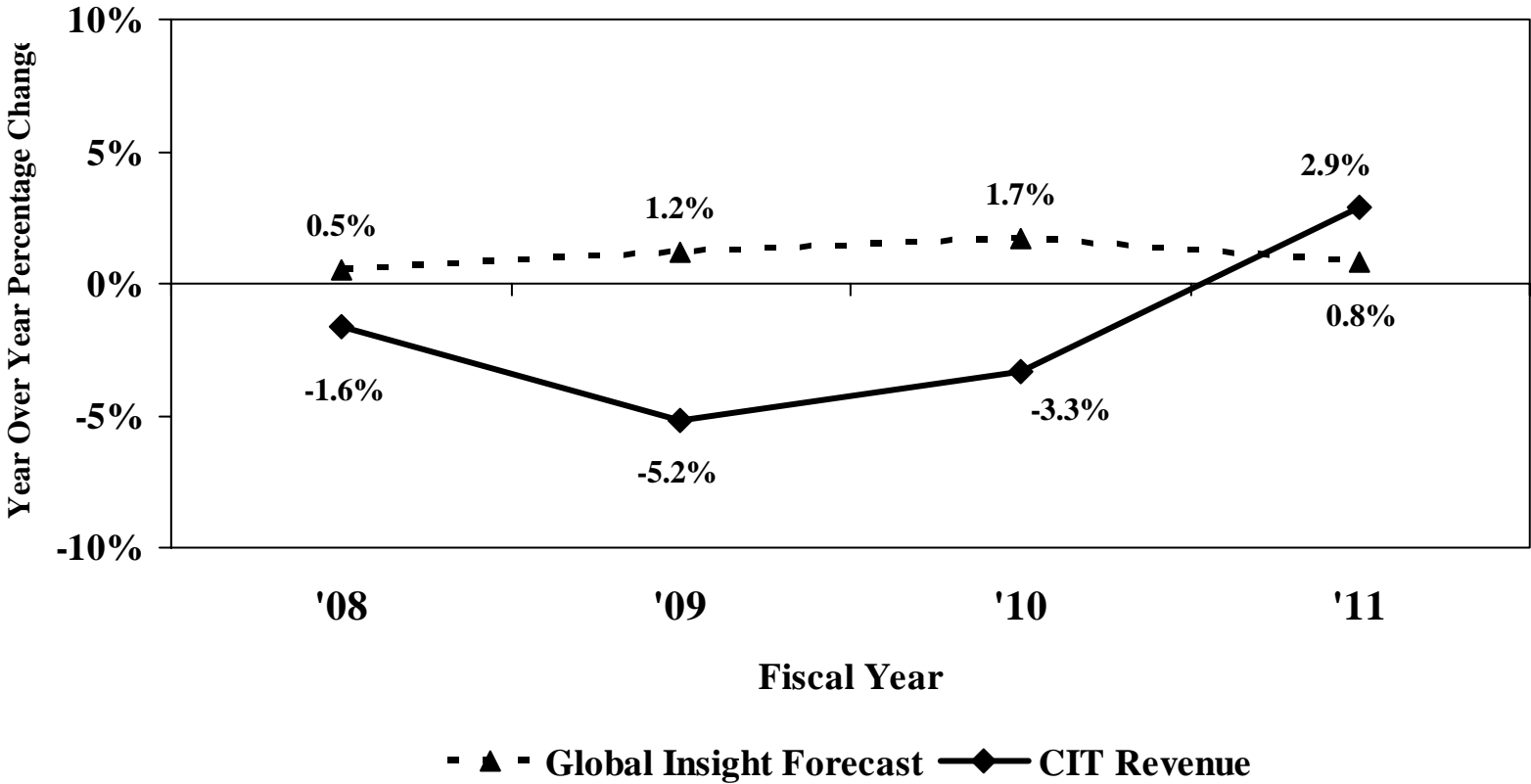
# Corporate Income Tax Projected to Decline in Both FY '08 and FY '09



\* Includes reduction for tax law changes.

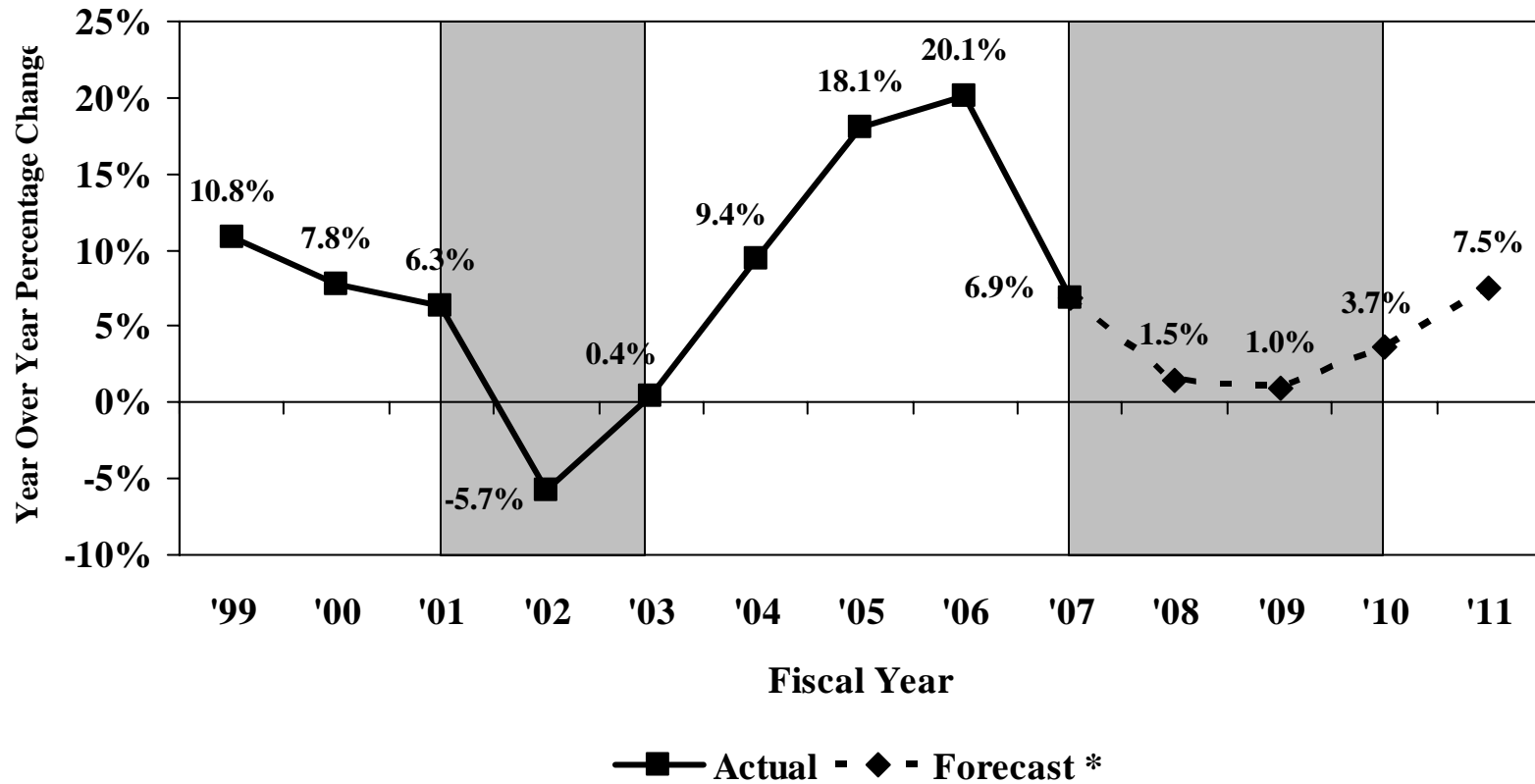
# U.S. Corporate Profits are Expected to Slow

- National Forecasts Generally Support  
4-Sector Revenue Projection



# Growth Remains Slow Until FY 2011

- September Forecast Had Similar “U” Shaped Curve



\* 4-sector forecast weighted average growth.

## **4-Sector Projections Further Increase Budget Shortfall**

- FY '08 budget shortfall is projected to be \$970 million.
- If none of FY '08 solutions are on-going, FY '09 budget shortfall is \$1.8 billion.

# FY 2008-FY 2011 Quartile Forecast Worksheet

	<u>FY 2008</u>	<u>FY 2009</u>	<u>FY 2010</u>	<u>FY 2011</u>
<b><u>Sales Tax</u></b>				
JLBC Forecast (11/07)	2.5%	3.0%	4.9%	6.7%
UA - Low (11/07 revision)	-1.9%	-4.3%	-0.1%	6.3%
UA - Base (11/07 revision)	-1.1%	-1.3%	3.7%	8.8%
FAC (12/10/07 Survey)	1.7%	3.5%	6.8%	9.4%
<b>Average:</b>	<b>0.3%</b>	<b>0.2%</b>	<b>3.8%</b>	<b>7.8%</b>
<b><u>Individual Income Tax</u></b>				
JLBC Forecast (11/07)	3.0%	4.8%	6.8%	7.8%
UA - Low (11/07 revision)	0.6%	-0.6%	0.3%	5.2%
UA - Base (11/07 revision)	5.8%	3.7%	3.9%	7.7%
FAC (12/10/07 Survey)	2.1%	3.1%	7.1%	9.2%
<b>Average:</b>	<b>2.9%</b>	<b>2.8%</b>	<b>4.5%</b>	<b>7.5%</b>
<b><u>Corporate Income Tax</u></b>				
JLBC Forecast (11/07)	1.9%	3.2%	2.2%	7.8%
UA - Low (11/07 revision)	1.6%	-8.5%	-5.5%	5.5%
UA - Base (11/07 revision)	4.9%	-2.3%	0.5%	2.7%
FAC (12/10/07 Survey)	-2.4%	-1.5%	2.2%	7.8%
<b>Average:</b>	<b>1.5%</b>	<b>-2.3%</b>	<b>-0.2%</b>	<b>6.0%</b>
<b>Consensus Weighted Average:</b>	<b>1.5%</b>	<b>1.0%</b>	<b>3.7%</b>	<b>7.5%</b>
<b>JLBC Weighted Average:</b>	<b>2.6%</b>	<b>3.8%</b>	<b>5.4%</b>	<b>7.3%</b>
<b>UA Low Weighted Average:</b>	<b>-0.5%</b>	<b>-3.2%</b>	<b>-0.5%</b>	<b>5.8%</b>
<b>UA Base Weighted Average:</b>	<b>2.3%</b>	<b>0.7%</b>	<b>3.4%</b>	<b>7.7%</b>
<b>FAC Consensus Weighted Average:</b>	<b>1.4%</b>	<b>2.8%</b>	<b>6.5%</b>	<b>9.2%</b>



Forecast percentages are prior to tax law changes.



# National Economic Outlook

Presented by:

**Elliott D. Pollack**

Presented for:

**Finance Advisory Committee**

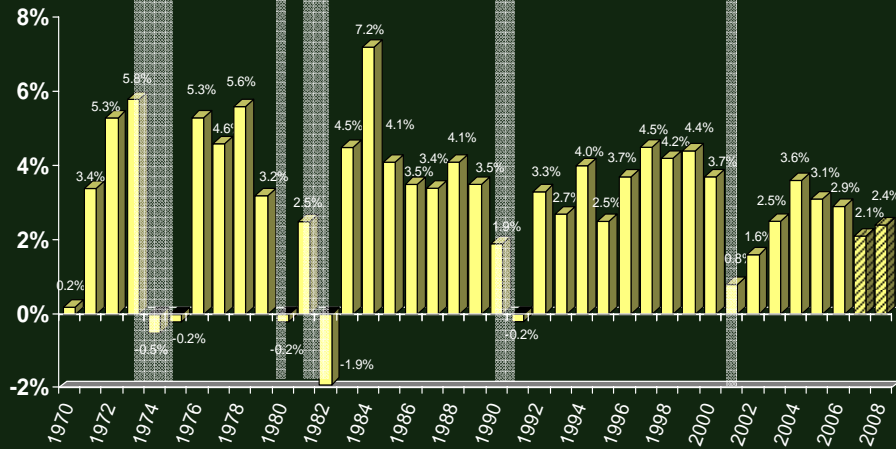
December 10<sup>th</sup>, 2007



**What  
causes  
economies  
to slow  
and where  
do we  
stand?**

# 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, November 2007

Recession Periods

## ODDS OF A RECESSION

Source: National Blue Chip Panel

November 07 consensus: 33.6%

September 07 consensus: 32.1%

August 07 consensus: 25.8%

November 06 consensus: 24.8%

Odds of a recession survey question was not asked in October 2007  
November's survey was conducted November 5<sup>th</sup> and 6<sup>th</sup>, 2007

## Is a RECESSION Imminent?

Economic expansions do not die of old age.

They die from:

1. Structural imbalances
  2. Fiscal and monetary policy errors
- ...Combined with unusual shocks

## TYPICAL IMBALANCES

- Consumers holding too much debt
- Real incomes decline
- Excess capacity
- Business has too much debt
- Too much inventory
- Employment markets too tight
- Inflation
- Bad tax policy
- Bad monetary policy

**Few of these imbalances presently exist to any significant degree.**

## **PRESENTLY**

- **Employment still growing**
- **Real incomes growing**
- **Business awash in cash**
- **Capacity utilization at a level associated with increases in plant spending**
- **Employment markets do not appear to be tight**
- **Inflation still appears under control**
- **Exports booming**
- **Fed has reacted well**

**The economy is no longer running on 8 cylinders; more like 3 or 4, but still driving forward....**

**...Slowly.**



**...hopefully.**



**LAST YEAR  
WE SAID:**

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



## **Examples of Direct Shocks:**

- **Unexpected oil supply disruption.**
- **Unexpected oil price escalation.**
- **Terrorist event (especially to financial or commerce infrastructure).**
- **Decline in housing prices.**

## **THIS YEAR'S SHOCK:**

- **Housing prices**
- **Mortgage backed securities**

**Liquidity dried up...**



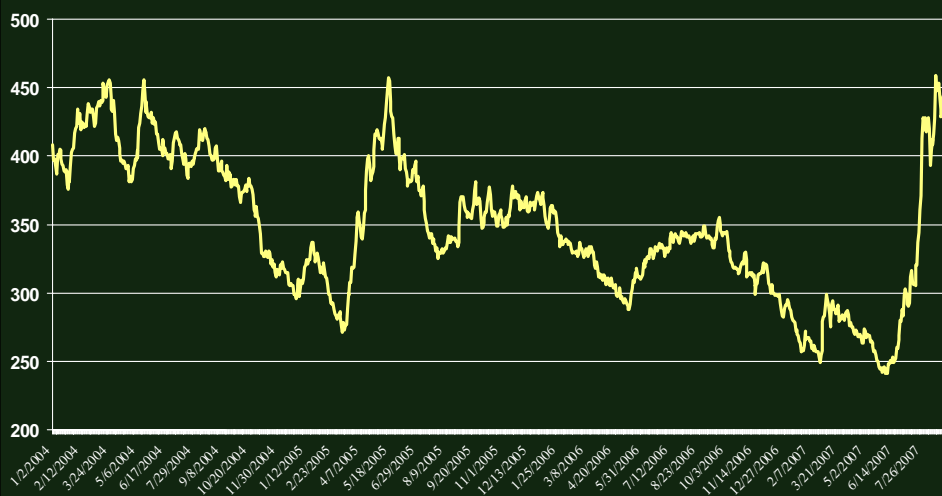


# Market re-prices risk.



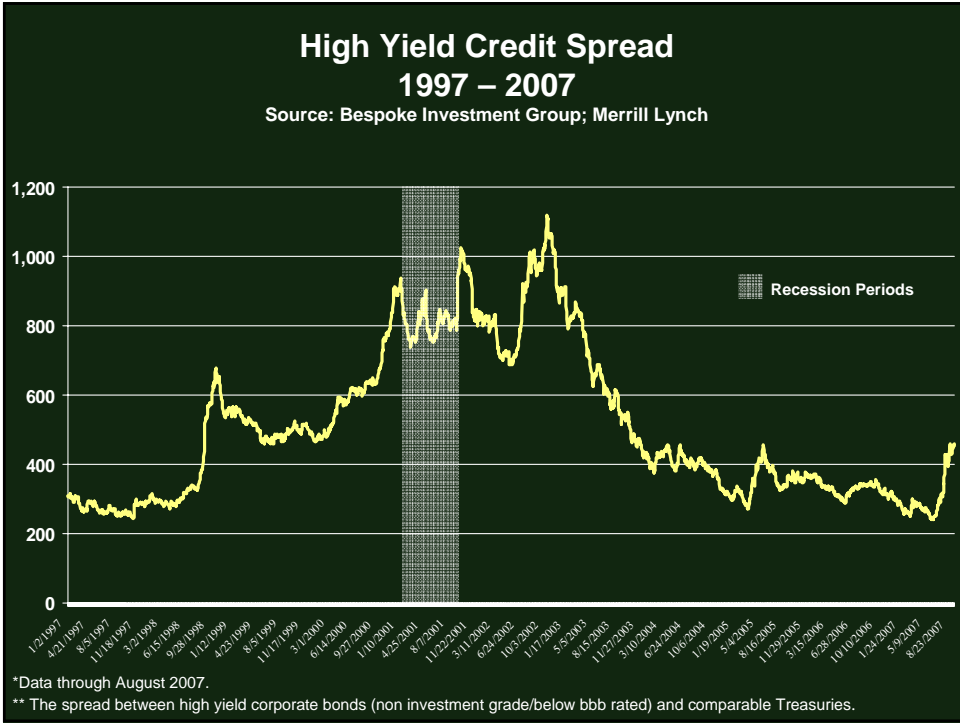
## High Yield Credit Spread 2004 – 2007

Source: Bespoke Investment Group; Merrill Lynch



\*Data through August 2007.

\*\* The spread between high yield corporate bonds (non investment grade/below bbb rated) and comparable Treasuries.



# Credit Crunch

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**Banks and others  
significantly curtail their  
lending to all sectors.**

## **Problem Areas Linked to Most Leveraged Sectors**

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- **Mortgage Backed Bonds**
- **Leveraged Buyout Loans**
- **Junk Bonds**

## **To Get a *Full Blown* Credit Crunch you need:**

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### **1. FEAR –**

**Of big losses on current & future loans.**

### **2. UNCERTAINTY –**

***How big* will the losses be?**

***When* will the market stabilize?**

***At what price* will it stabilize?**

## **NOW – A Limited Credit Crunch**

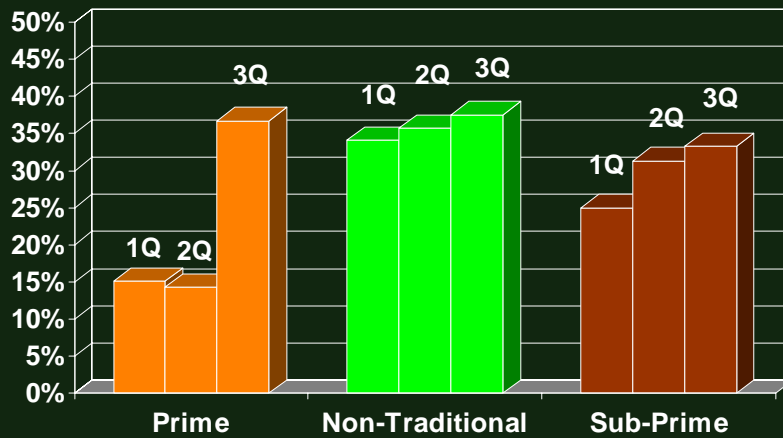
**The crunch has not yet spread  
to the general economy.**

### **Characteristics of a Limited Credit Crunch:**

- **Banks are still lending to consumers & businesses.**
- **Credit card agencies are still issuing credit.**
- **Mortgage lenders are still lending to qualified borrowers.**

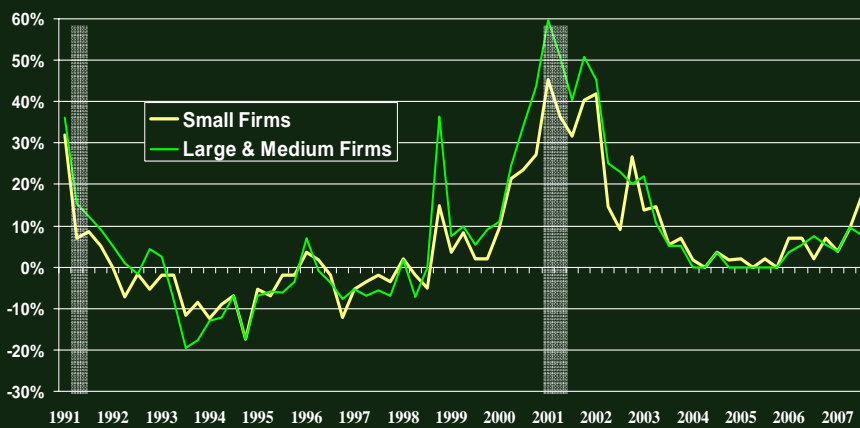
### Net Percentage of Large U.S. Banks Reporting Tougher Standards on Residential Loans 2007

Source: Federal Reserve, Board of Governors



### Net Percentage of Large U.S. Banks Reporting Tougher Standards on Business Loans 1991 – 2007\*

Source: Federal Reserve, Board of Governors



\*Data as of October 2007 survey.

Recession Periods

# Net Percentage of Large U.S. Banks Reporting Tougher Standards on Consumer Loans

1997 – 2007\*

Source: Federal Reserve, Board of Governors



\*Data as of October 2007 survey.

Recession Periods

# ACTIONS OF THE FED















































































































