

STATE OF ARIZONA

**Joint Legislative Budget Committee**

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SENATE

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**FINANCE ADVISORY COMMITTEE**

**January 13, 2009**

**Senate Hearing Room 1 – 9:30 a.m.**

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Members Present:

Dan Anderson, Arizona Board of Regents  
Dr. Jay Butler, Morrison School, ASU Polytechnic  
Brian Cary, Salt River Project  
Tracy L. Clark, Arizona Department of Transportation  
Dennis Doby, Arizona Department of Commerce  
John Lucking, ECON-LINC  
Dean Martin, State Treasurer  
Georganna Meyer, Arizona Department of Revenue  
Elliott Pollack, Elliott D. Pollack and Company  
Debra Roubik, VisionEcon  
Martin Shultz, Pinnacle West Capital Corporation  
Randie Stein, Stone & Youngberg  
Marshall Vest, Eller College of Management

Mr. Richard Stavneak, Director, JLBC Staff, opened the meeting at 9:54 a.m. and welcomed everyone to the Finance Advisory Committee (FAC) meeting. The panel meets 3 times a year to discuss the economy and to provide the Legislature with guidance on state revenue projections. Mr. Stavneak stated that materials being presented are also on the JLBC website.

Mr. Stavneak, Mr. Eric Jorgensen, Mr. Hans Olofsson, and Mr. Martin Lorenzo, gave the JLBC Staff presentation with an overview of state revenues. ([Click here to view.](#))

In response to a question from Representative Barnes, Mr. Stavneak gave an overview of how the forecasts are made.

Mr. Elliott Pollack, Elliott D. Pollack & Company, gave a slide presentation on the national economy. ([Click here to view.](#))

Senator Leff asked what the rationale is for banks not giving prime loans or non-risk loans to people. Mr. Pollack responded that the banks are more concerned with surviving than they are with making loans. They want to build up their capital because they are afraid they are going to have massive losses in commercial real estate and credit cards, and they need capital to write those losses off. The banks are not as concerned with making money, they are more concerned with not losing money.

(Continued)

Mr. Pollack had a slide that stated that of the homes purchased over the past 5 years, an average of 41.8% have negative equity. An audience member stated that seemed high. He asked what that figure would have been 3-5 years ago. Mr. Pollack responded he did not have the exact figure, but his guess would be that 5 years ago the number would be 0.

Mr. Stavneak asked Mr. Pollack what signs he would look for to indicate the economy is turning around. Mr. Pollack stated he would look at employment, hours worked, and excess supply of houses.

Mr. Marshall Vest, Eller College of Management, University of Arizona, gave a slide presentation on the state economy. ([Click here to view](#)).

In response to a question from the audience, Mr. Vest explained how layoffs are determined in the unemployment percentage. Mr. Dennis Doby, Department of Commerce, added that there is a quota sample that is representative of small, large, and big businesses. The model tries to take layoffs into account. An individual firm may not show up, but the overall model tries to capture, on a representative basis, losses in small, medium and large firms. Layoffs eventually show up when benchmarking is done the next year.

A member of the audience asked if it is recommended that the state accept a Federal stimulus package. Mr. Stavneak stated that the members would need to find out first the dollar amount. Secondly, they would need to evaluate what strings are attached. He noted that it is difficult to make the determination ahead of time until we know what the dollar level is and what strings are attached.

In response to a question from the audience regarding population decline, Mr. Vest stated that population growth slows down during a recession partly because people can not sell their homes back home, and because they are generally more cautious. Population is still growing, but not as rapidly. Migration in Arizona is still positive.

An audience member asked if Mr. Pollack agreed with the Federal Government bailout. Mr. Pollack stated that Mr. Bernanke, the Federal Reserve Chairman, is the most knowledgeable person about the depression alive. Mr. Bernanke has vowed to make sure a depression does not happen again, so he is adding liquidity to the system. This is about adding bank capital to keep the banking system afloat, because the economy floats on a sea of credit and if the banking system can not provide credit, the system will fail. So this is a short term fix in order to have a long term banking system that is viable. Mr. Pollack believes that Mr. Bernanke did what he had to do to keep the banking system afloat in order to provide capital. In Mr. Pollack's opinion, we would be in a lot worse shape if he had not done this.

Mr. Vest added that the Federal Government has tried to identify those markets that have systemic risks. The Feds started with the idea of pumping a lot of money into the largest banks, including short term loans which are paid back with interest, and by buying assets on the books of the banks. Mr. Vest noted that this is not a giveaway, but is really an investment by the Federal Government. He said that when there is a total breakdown in the private sector, the Fed sees its role as a lender of last resort, and they have attempted to provide the capital that is necessary to keep things going.

A member from the audience asked a question regarding what is happening on the taxation front. Mr. Pollack stated that on a Federal level it is pretty clear that the President-elect has moved from tax increases to tax cuts, especially for the middle class and below. It is his expectation that any tax increases will be put on the back burner for quite some time and that the bailout and further actions will be financed through deficit spending, because when push comes to shove, we could sell U.S. Treasury Bills. The Bush tax cuts will expire in 2010. Unless something is done, taxes will go up. A lot of what happens depends on the advice President-elect Barack Obama gets. Mr. Pollack stated that he is impressed with

(Continued)

the economic team the President-elect has put together. They are people who have a lot of experience and who, in his opinion, know what they are doing.

Mr. Dean Martin, State Treasurer, gave a handout to members and made a presentation regarding the state budget. (*See Attachment 1*)

The meeting adjourned at 11:54 a.m.

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Sandy Schumacher, Secretary

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Tim Everill, Assistant Director

NOTE: A full audio recording of this meeting is available at the JLBC Staff Office, 1716 W. Adams. A full video recording of this meeting is available at <http://www.azleg.gov/jlbc/meeting.htm>.

# **Finance Advisory Committee**

**January 13, 2009**

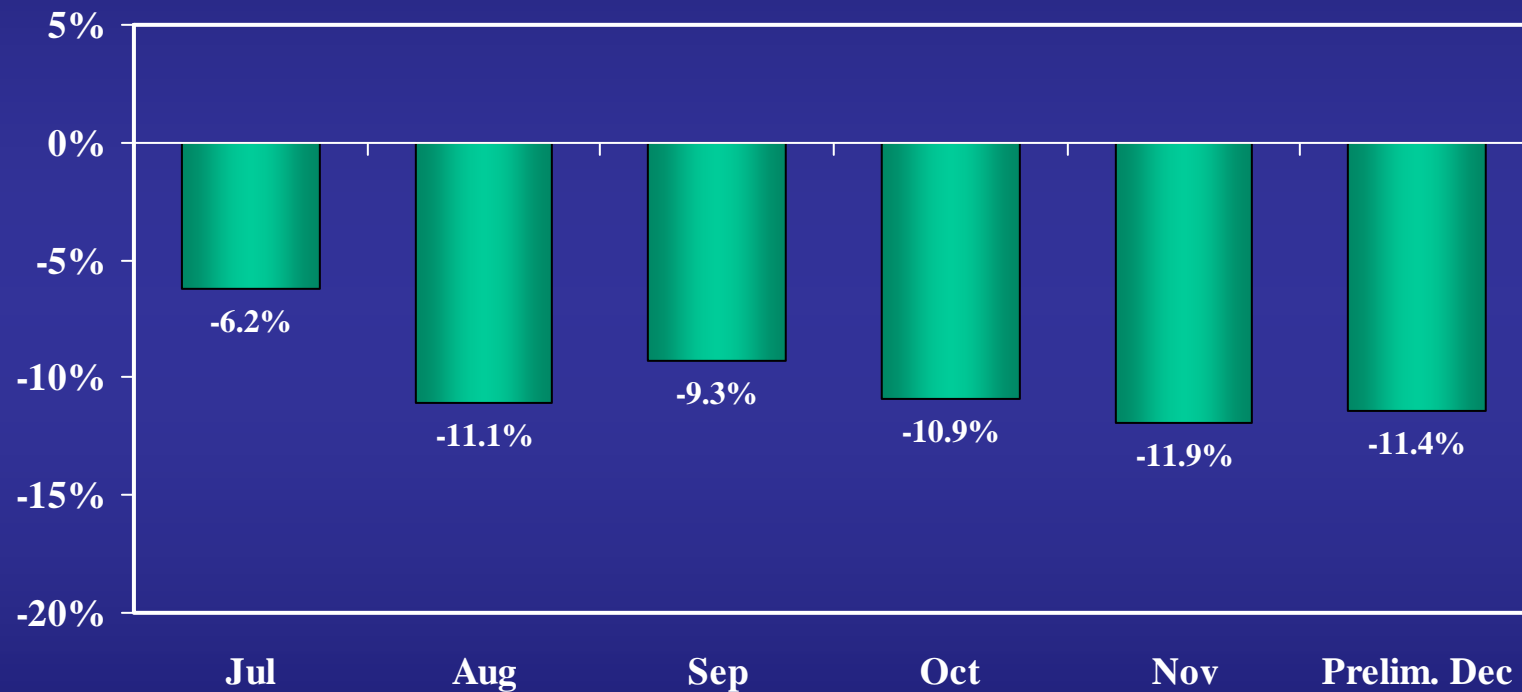
**JLBC**

## **FY '09 Revenues Will Need to Grow By 6.1% to Meet \$10.0 B Budgeted Level**

- Original budgeted FY '09 growth compared to enacted '08 Budget 1.9%
- Growth adjusted for lower '08 Base 6.1%

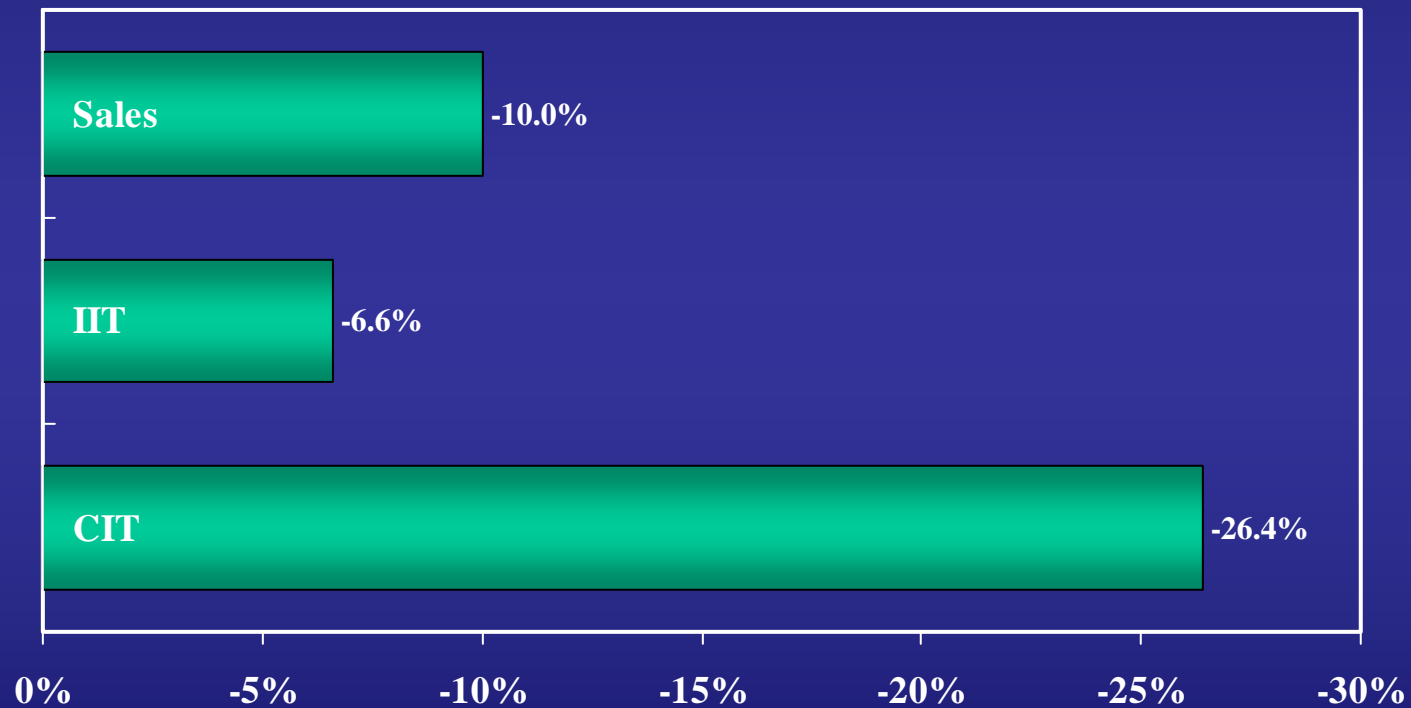
# '09 Revenue Collections Continuing to Decline

- First Half-Year Decline = (10.1)%



Percent Change Below FY 2008

# All Major Tax Categories Declined in the 1<sup>st</sup> Half of FY '09



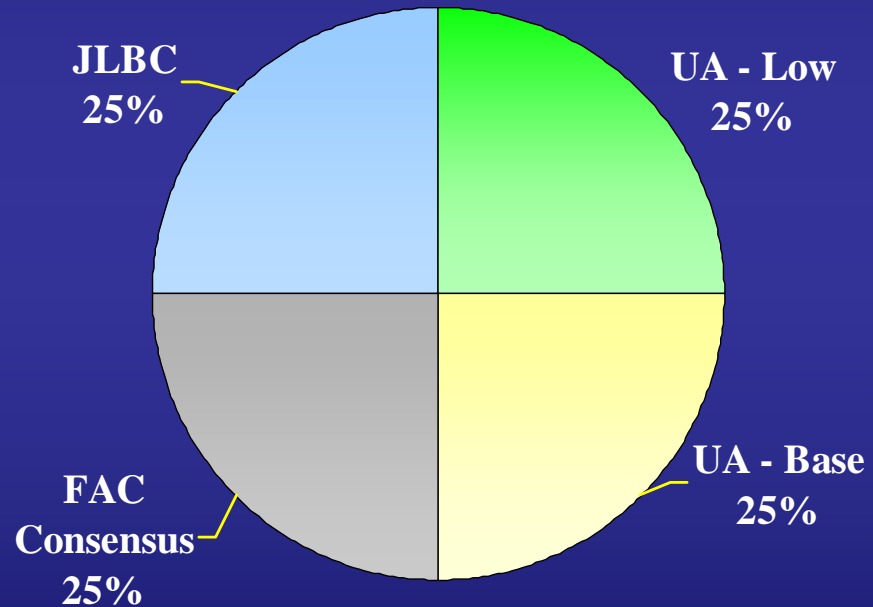
Excludes statutory and one-time changes.

# 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 (9% of total) are staff forecast



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



# Sales Tax

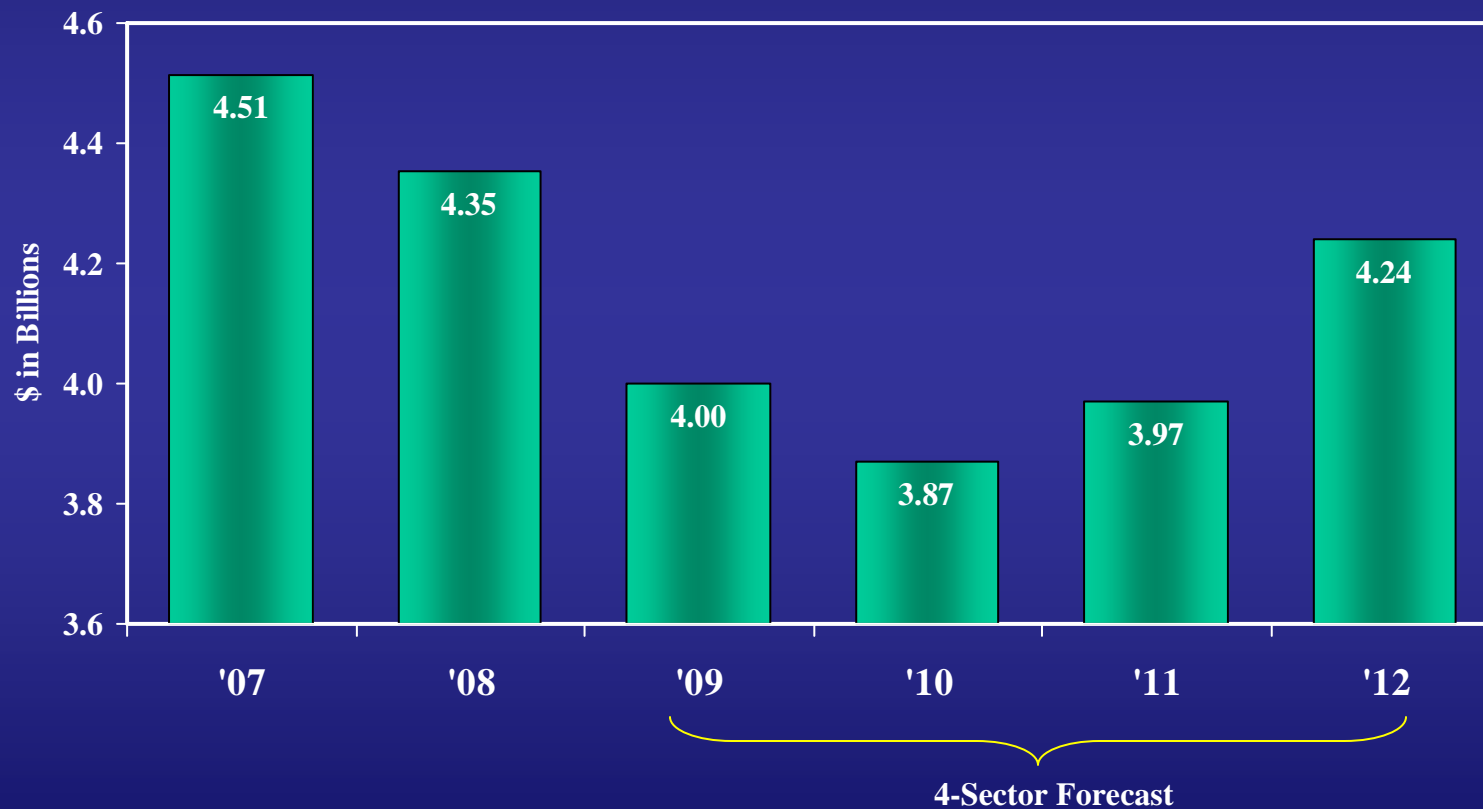
- The Consensus Forecasts Declines of (8.2)% in '09 and Another (3.2)% in '10



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

# Sales Tax

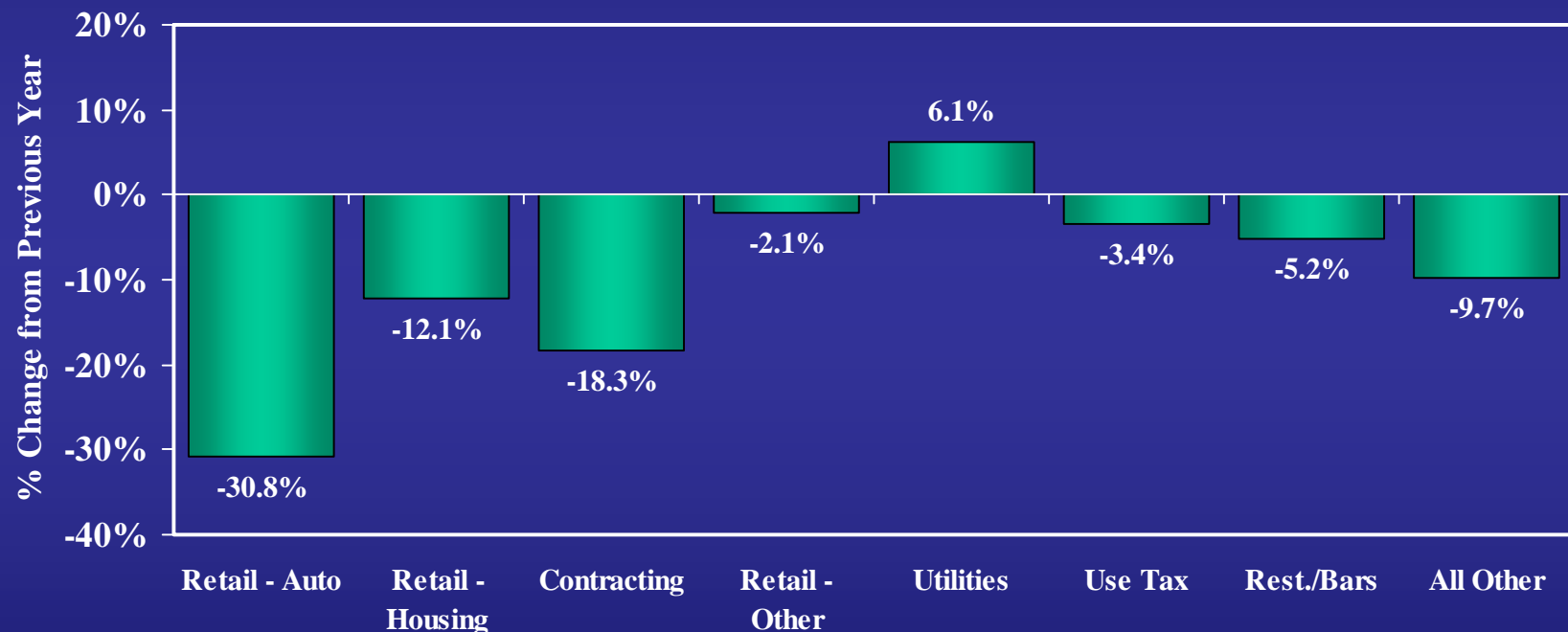
## - Collections Below FY '07 Level Until FY '13



Includes enacted tax law changes.

# Construction and Vehicle Spending Have Declined Significantly

- Represents 37% of Sales Tax Collections



FY 2009 Year to Date Sales Tax Revenues – (Through November)

# Individual Income Tax

- The Consensus Forecasts Declines of (7.2)% in '09 and Another (2.8)% in '10



\* Excluding the 10% phased-in rate reduction, growth would have been 6.3% in '07, and (4.1)% in '08.

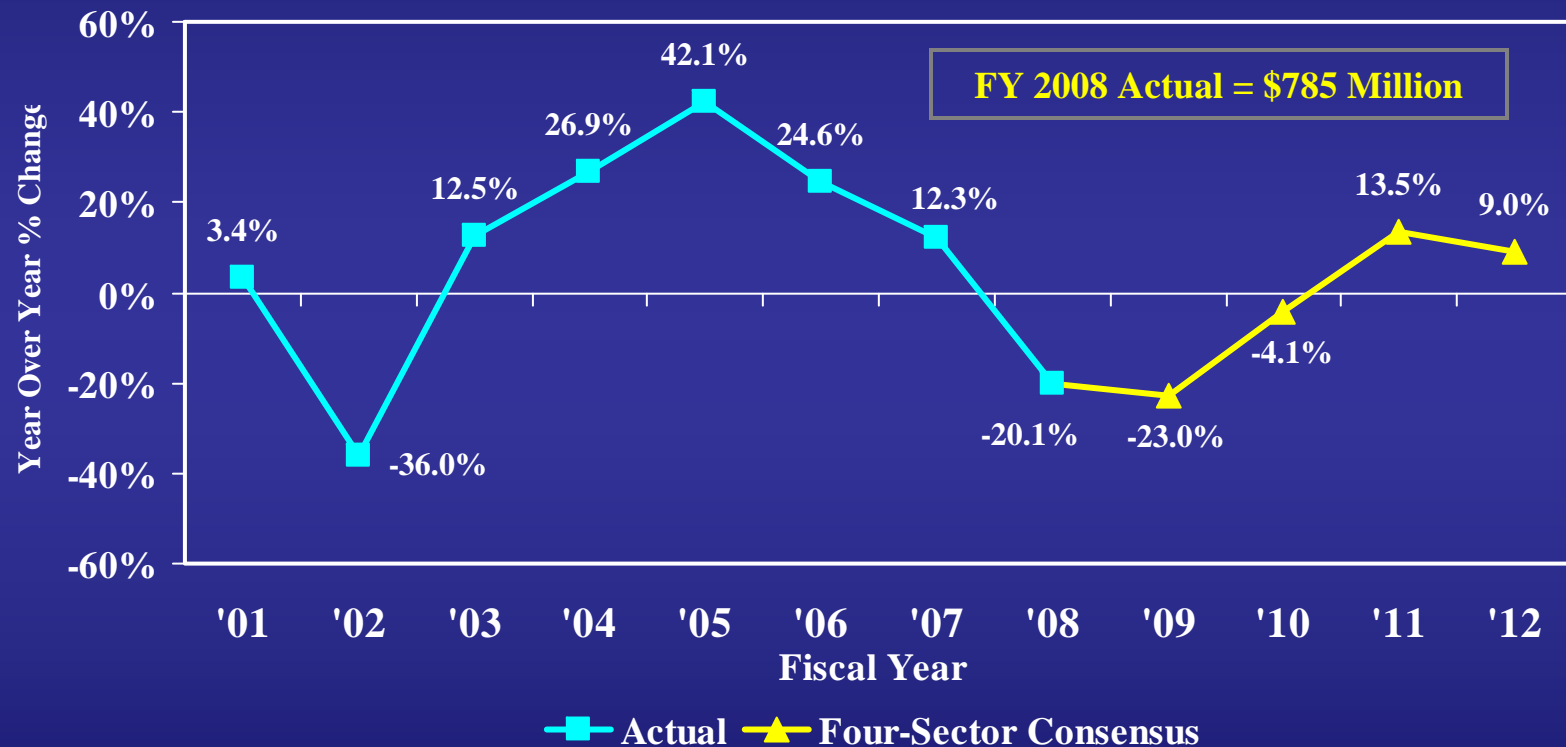
## **Individual Income Tax**

### **- Weakness In Both Withholding and Payment Categories**

- Ongoing job losses are adversely affecting withholding tax collections.
- Year to date, withholding is down by (1.8)% and is likely to decline further.
- Estimated payments have declined year-over-year in 14 of the last 18 months.
- Year to date, payments are down by (16.2)%.

# Corporate Income Tax

- The Consensus Forecasts Declines of (23.0)% in '09 and Another (4.1)% in '10

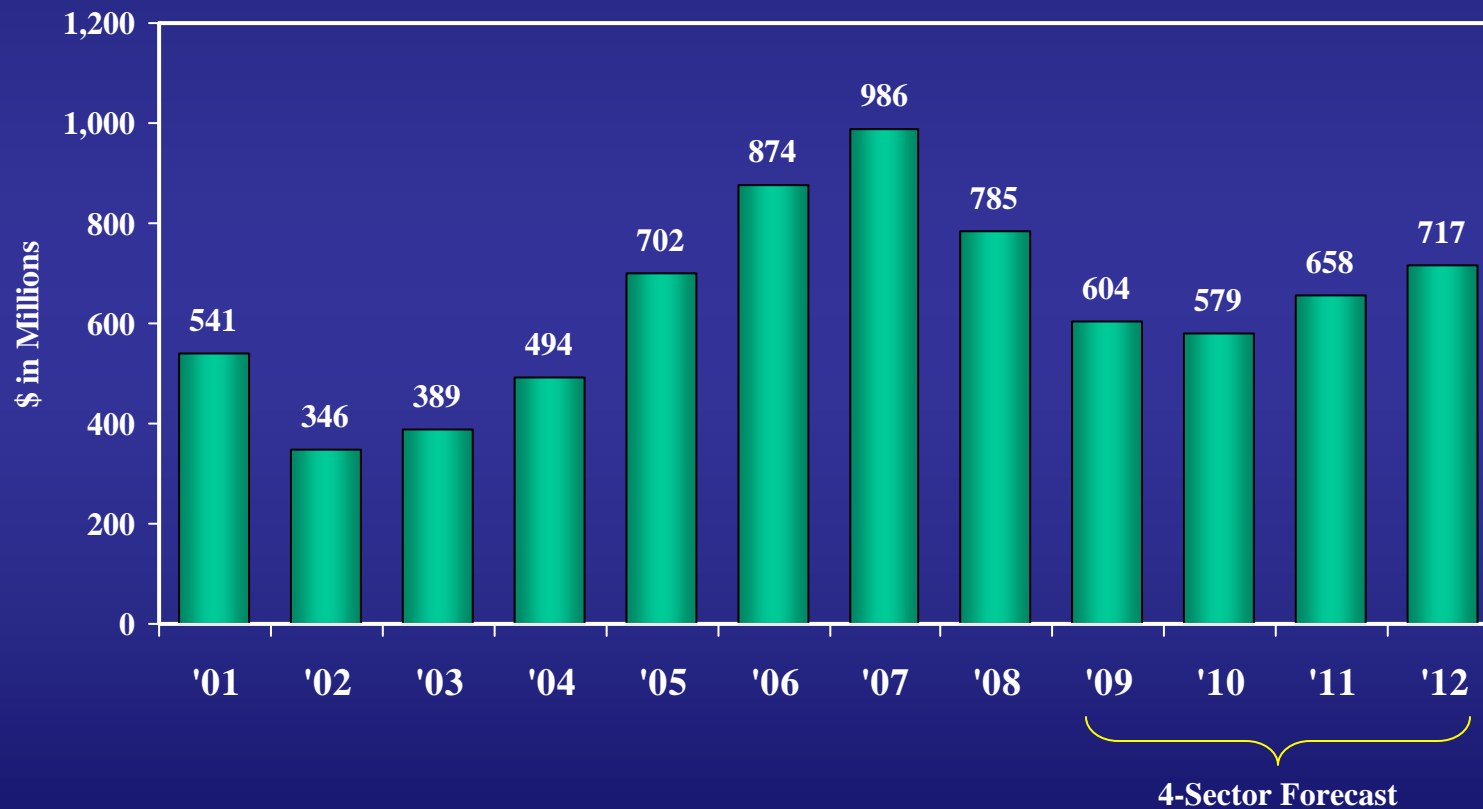


\* Excluding tax law changes, growth would have been 12.8% in '07, and the '08 decrease would have been (14.7)%.

\*\* In FY '09-11, there will be an additional incremental loss associated with the phase in of the corporate sales factor legislation.

# Corporate Income Tax

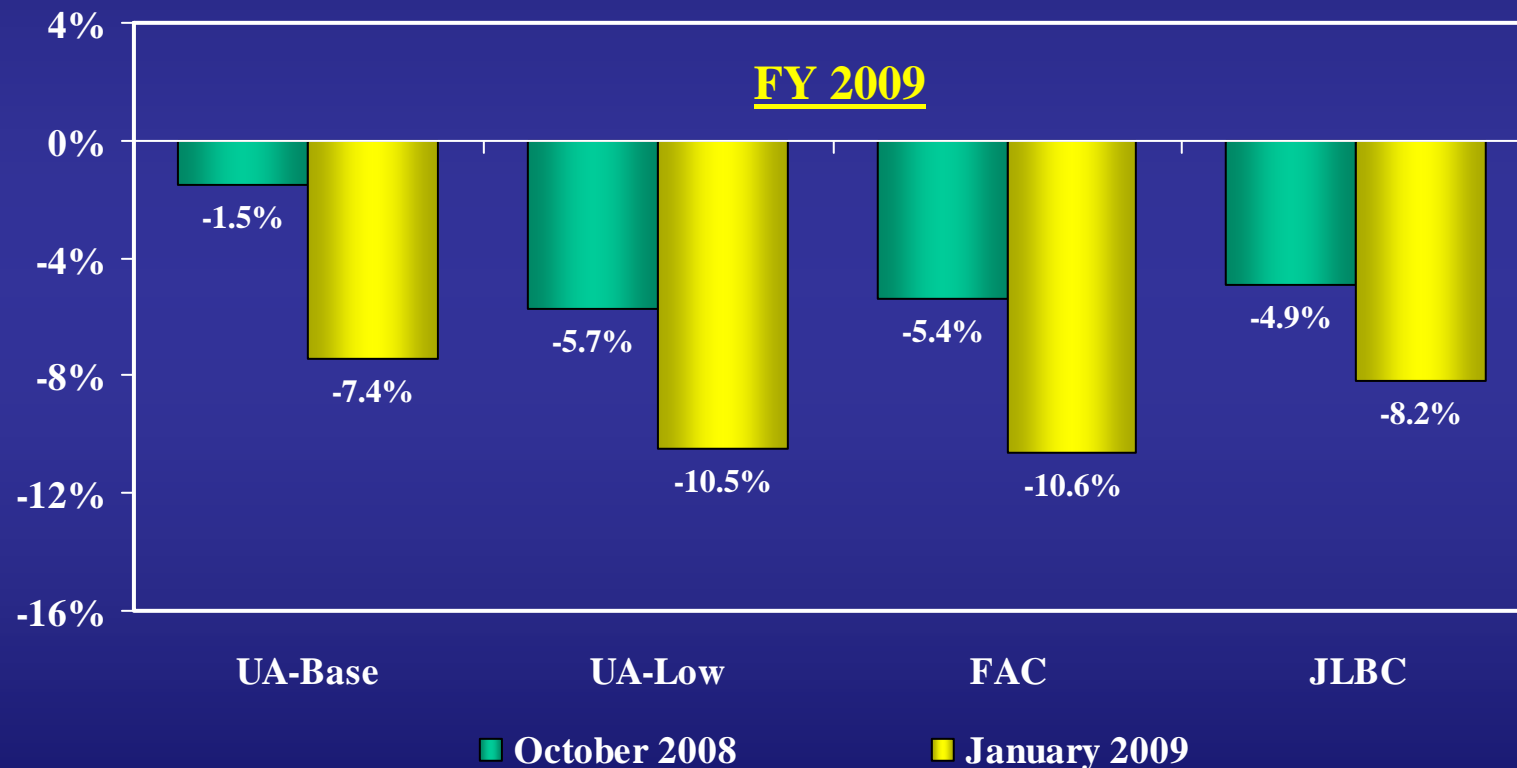
## - Collections Return to FY '05 Level in FY '12



Includes enacted tax law changes.

# January 4-Sector Projecting Revenue Decline of (9.2)% in FY '09

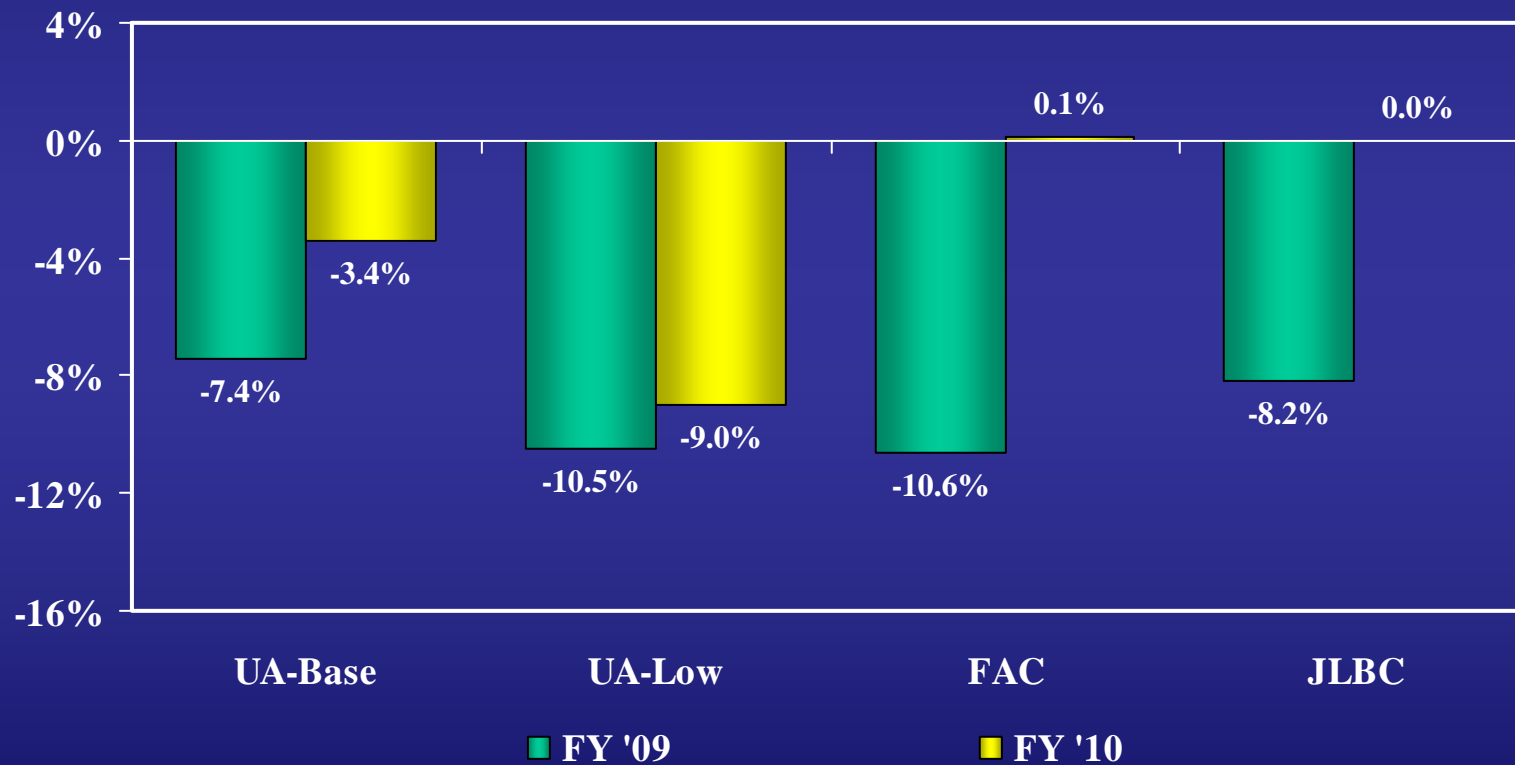
- October 2008 Forecast for FY '09 was (4.4)% Decline



Weighted Big 3 Average and JLBC Forecast for Small  
Categories Prior to Tax Law Changes



## Each Sector Shows Improvement for FY '10, But Overall Forecast Still A (2.8)% Decline



Weighted Big 3 Average and JLBC Forecast for Small  
Categories Prior to Tax Law Changes

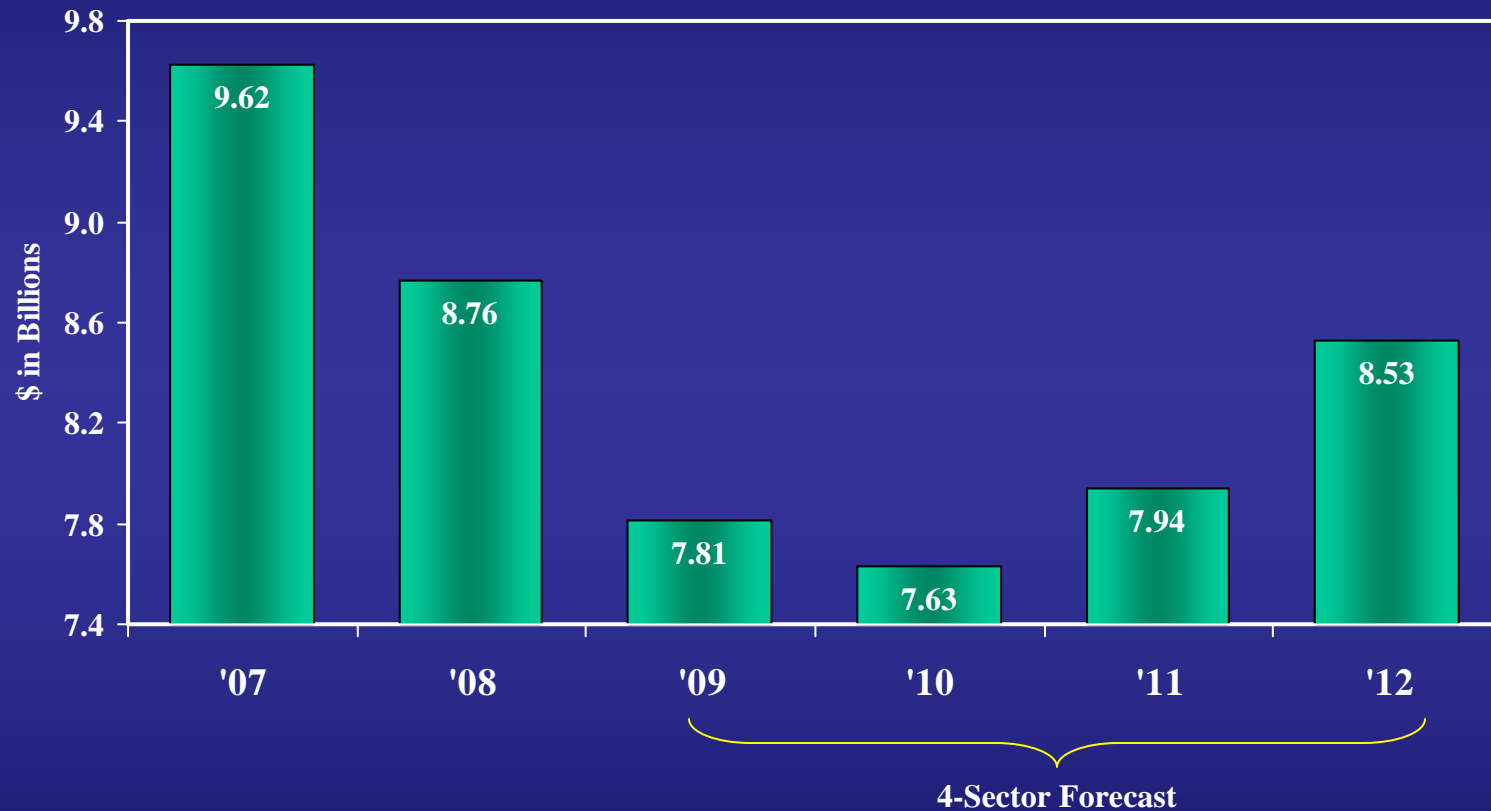
## 4-Sector Does Not Forecast Normal Growth Until FY 2012



\* 4-sector forecast weighted average growth.

# On-Going General Fund Revenue

- Collections Will Not Return to '07 Level Until After FY '12



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

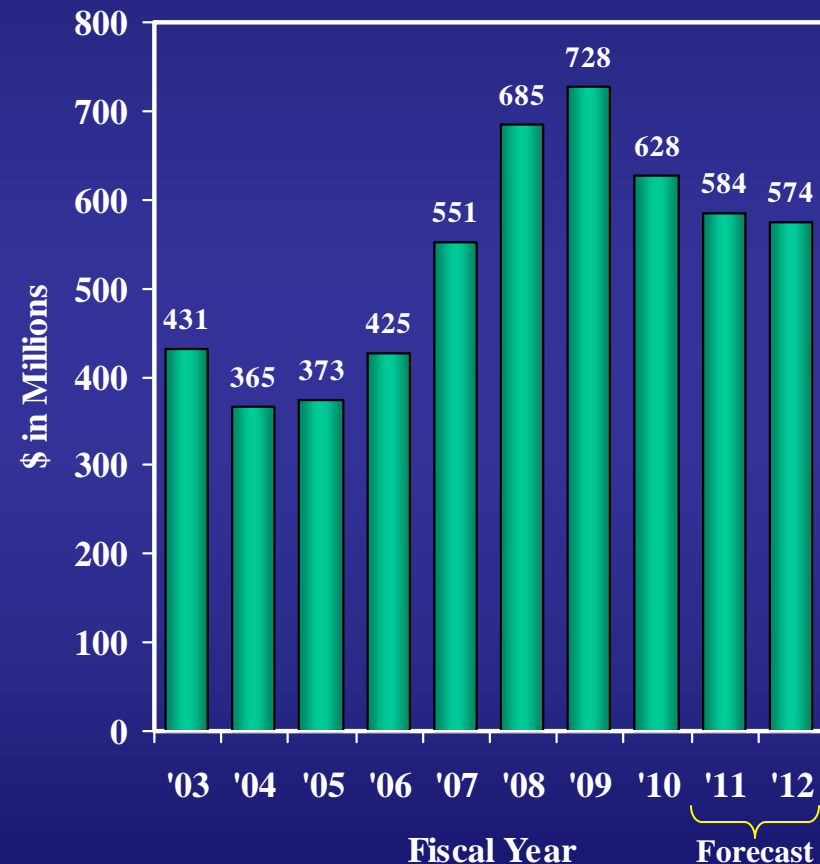
## **FY '10 Revenue Base Also Adjusted for Tax Laws and Urban Revenue Sharing**

- Tax law changes of \$(34) M.
  - Corporate sales factor phase-in \$(29) M, and Phoenix Convention Center payment \$(5) M.
- Urban Revenue Sharing decreases by \$(100) M from \$728 M in '09 to \$628 M in '10.
  - Of \$(100) M, \$(18) M is due to elimination of one-time special adjustments.
  - Remaining \$(82) M due to decline in income tax collections.

# Urban Revenue Sharing Volatility

## - Due to Link to Income Tax Collections

- Cities receive 15% of individual and corporate income tax collections from 2 years prior.



## FY2009-FY 2012 Quartile Forecast Worksheet

	FY 2009	FY 2010	FY 2011	FY 2012
<b><u>Sales Tax</u></b>				
JLBC Forecast	-6.3%	0.1%	4.3%	6.0%
UA - Low	-10.1%	-8.7%	-0.2%	6.6%
UA - Base	-8.8%	-4.2%	2.5%	7.9%
FAC Survey	-7.6%	0.1%	3.7%	6.9%
Average:	-8.2%	-3.2%	2.6%	6.9%
<b><u>Individual Income Tax</u></b>				
JLBC Forecast	-7.7%	-0.1%	6.5%	7.5%
UA - Low	-8.7%	-8.7%	-1.3%	5.2%
UA - Base	-3.1%	-2.2%	2.5%	6.2%
FAC Survey	-9.2%	-0.1%	4.7%	8.5%
Average:	-7.2%	-2.8%	3.1%	6.9%
<b><u>Corporate Income Tax</u></b>				
JLBC Forecast	-20.4%	0.0%	12.3%	4.1%
UA - Low	-20.2%	-12.6%	13.3%	11.4%
UA - Base	-18.2%	-4.9%	18.9%	5.9%
FAC Survey	-33.0%	1.3%	9.6%	14.5%
Average:	-23.0%	-4.1%	13.5%	9.0%
Consensus Weighted Average:	-9.1%	-3.1%	3.6%	7.0%
JLBC Weighted Average:	-8.2%	0.0%	5.8%	6.4%
UA Low Weighted Average:	-10.5%	-9.0%	0.4%	6.5%
UA Base Weighted Average:	-7.4%	-3.4%	3.8%	7.0%
FAC Consensus Weighted Average:	-10.6%	0.1%	4.5%	8.1%




# National Outlook 2009

Presented by:  
Elliott D. Pollack

Presented to:  
Finance Advisory Committee  
January 13<sup>th</sup>, 2009




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## Bail Out or no Bail Out

= a **BAD** year  
or  
a **TERRIBLE** year.



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## Credit Markets: Economics vs. Psychology



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## Government Economic Measures

1. Monetary Policy (rate changes),
2. GSE Reforms (Fannie/Freddie),
3. Money Mkt. Mutual Fund (MMMF) Guarantee,
4. Asset Backed MMMF Comm. Paper Liq. Facility,
5. Commercial Paper Funding Facility,
6. Increase Supply of Term Funds to Banks,
7. Expansion of Swap Agreements,
8. FDIC Temp Liquidity Guarantee Program,
9. Emergency Economic Stabilization Act ("bail-out package"),
10. FHA Hope for Homeowners(\$300B for mortgage assistance).

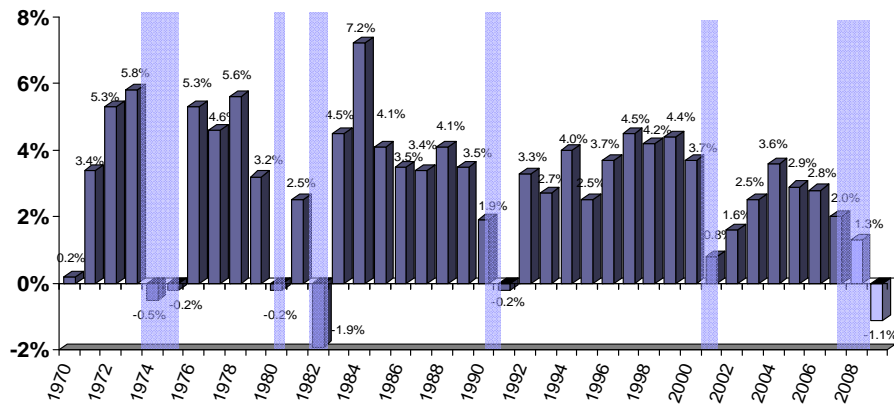


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## United States Real Gross Domestic Product\* Annual Growth 1970 - 2009\*\*

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



\* Based on chained 2000 dollars.

\*\* 2008 - 2009 are forecasts from the Blue Chip Economic Indicators, December 2008

Recession Periods



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## Basic Story

### Consumer

- Too much debt
- Not enough traditional savings
- Poor stock market and housing price performance
- Jobs and hours worked declining
- Prices on basics, such as oil + food, have been rising



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## The Result

### Consumer

- Consumer spending squeezed
- Big cuts in spending on durables
- Also cuts in non-durables and services

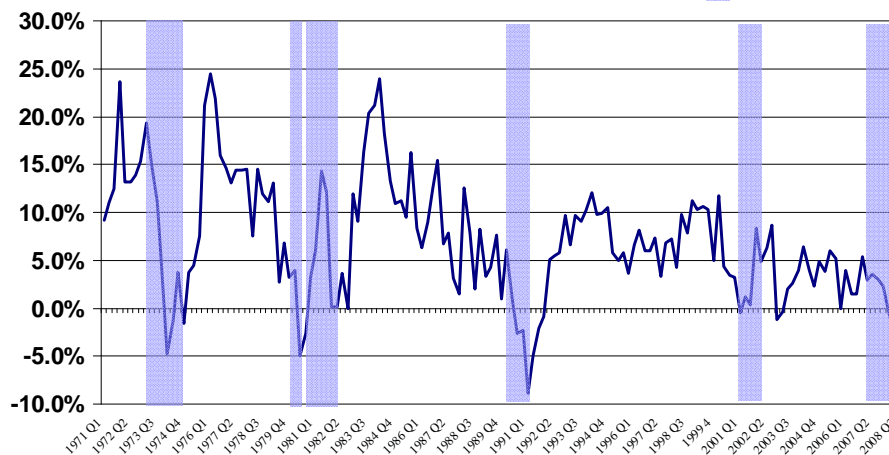


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### Consumer Spending on Durable Goods Percent Change Year Ago 1971 – 2008\*

Source: Bureau of Economic Analysis

Recession Periods



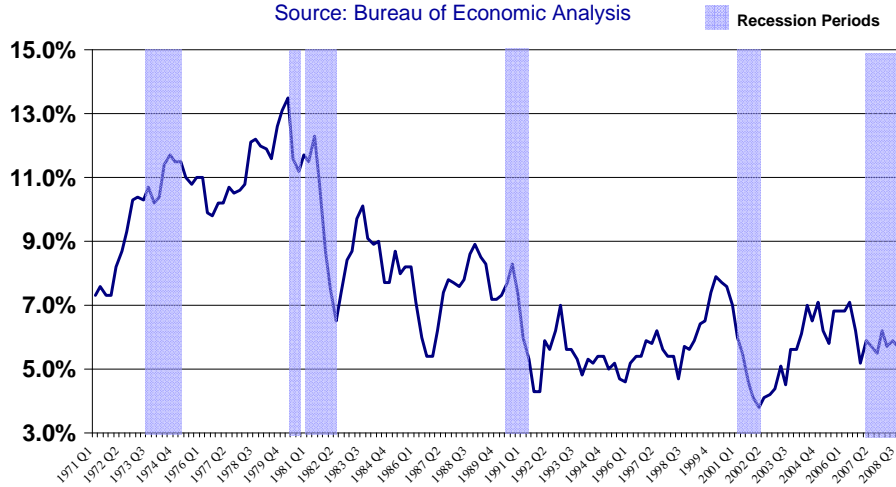
\* Data through third quarter 2008



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## Consumer Spending on Non-Durable Goods & Services Percent Change Year Ago 1971 – 2008\*

Source: Bureau of Economic Analysis



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\* Data through third quarter 2008

## Basic Story

### Business

- Has been strong due to weak dollar / strong exports
- Weakness in rest of world will hurt exports



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## The Result

### Business

- Business spending on plant & equipment will not be as strong as it has been
- Trade deficit will improve, but more slowly



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## Basic Story

### Housing

- Supply / demand imbalance continues
- No quick fix for credit markets
- Foreclosures to continue at high rates



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## The Result

### Housing

- Drag on economy from housing will end because comparisons so easy
- But drag on economy from commercial will get worse



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



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# How many more shoes can drop?



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There may  
be a few  
more shoes  
left to  
drop....



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# The Consumer

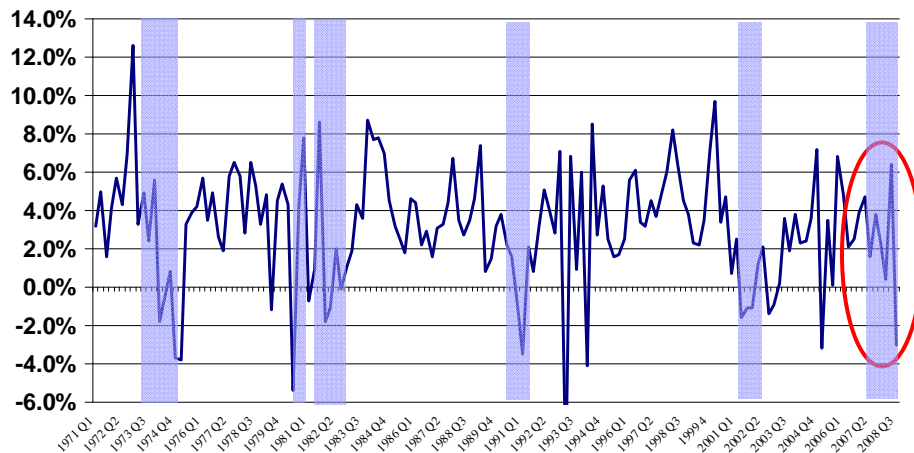


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## Real Personal Income Net of Government Transfers Percent Change Quarter Ago, Annualized 1971 – 2008\*

Source: Bureau of Economic Analysis

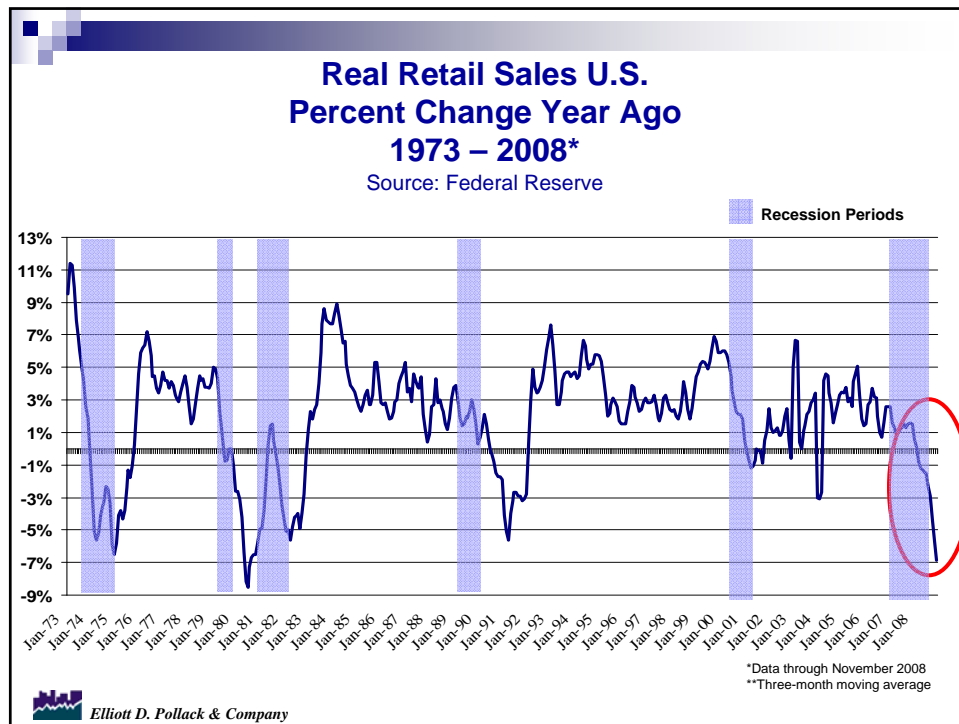
Recession Periods



\* Data through third quarter 2008



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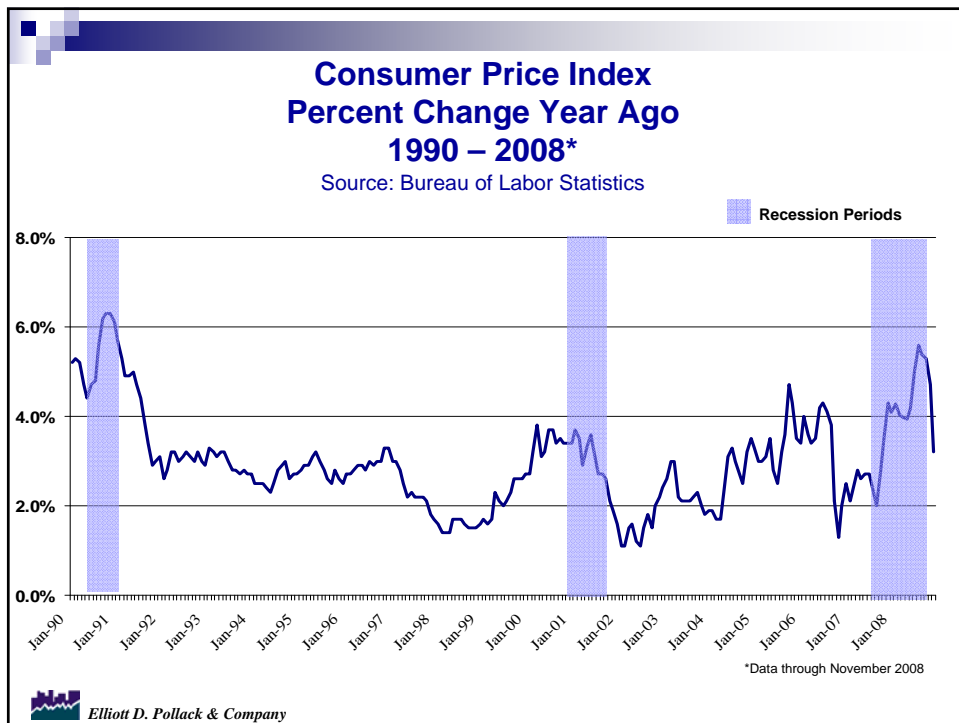
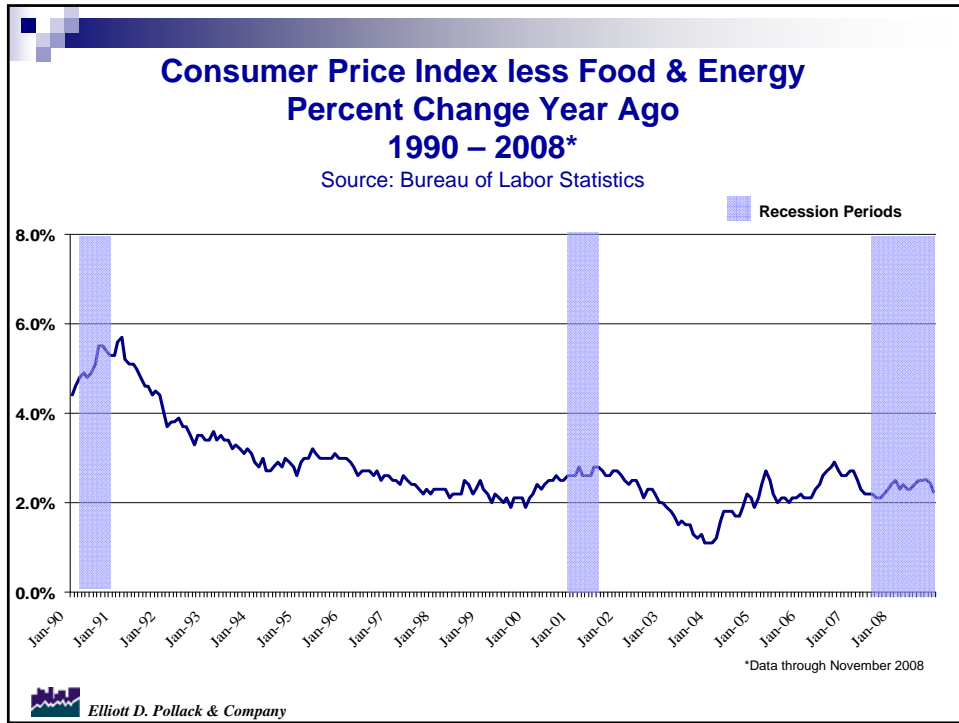
## Short-term: **deflation**

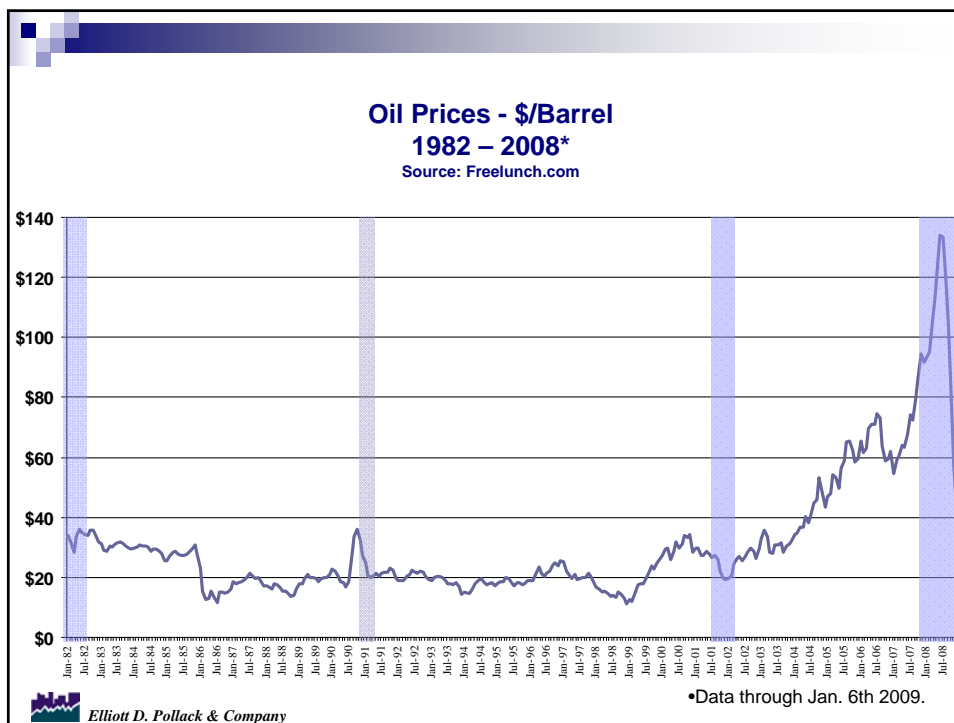
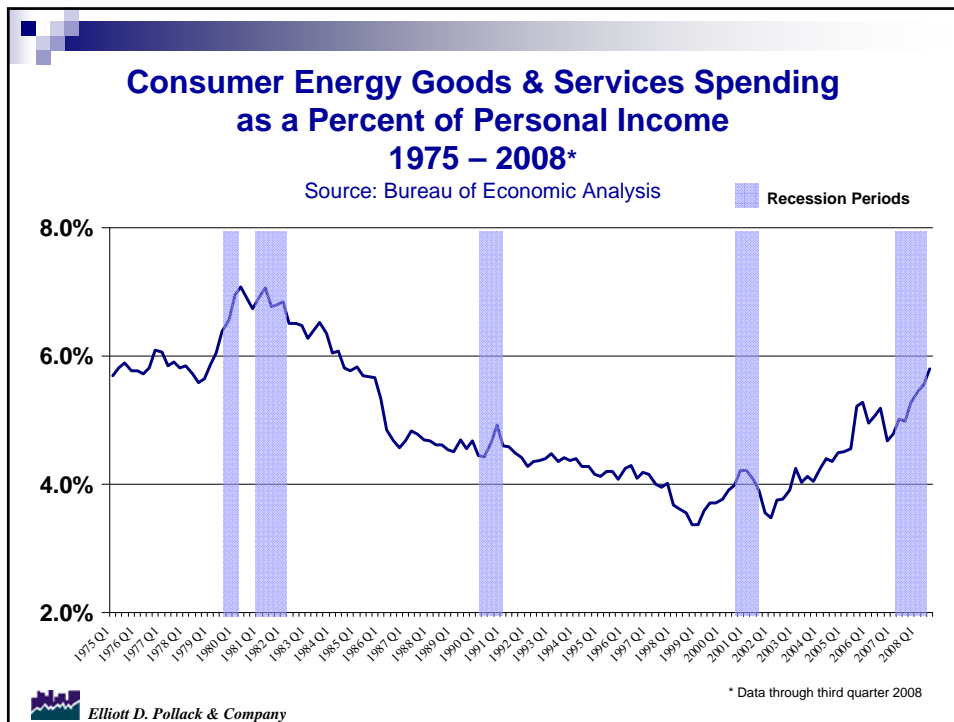
## Long-term: **inflation**

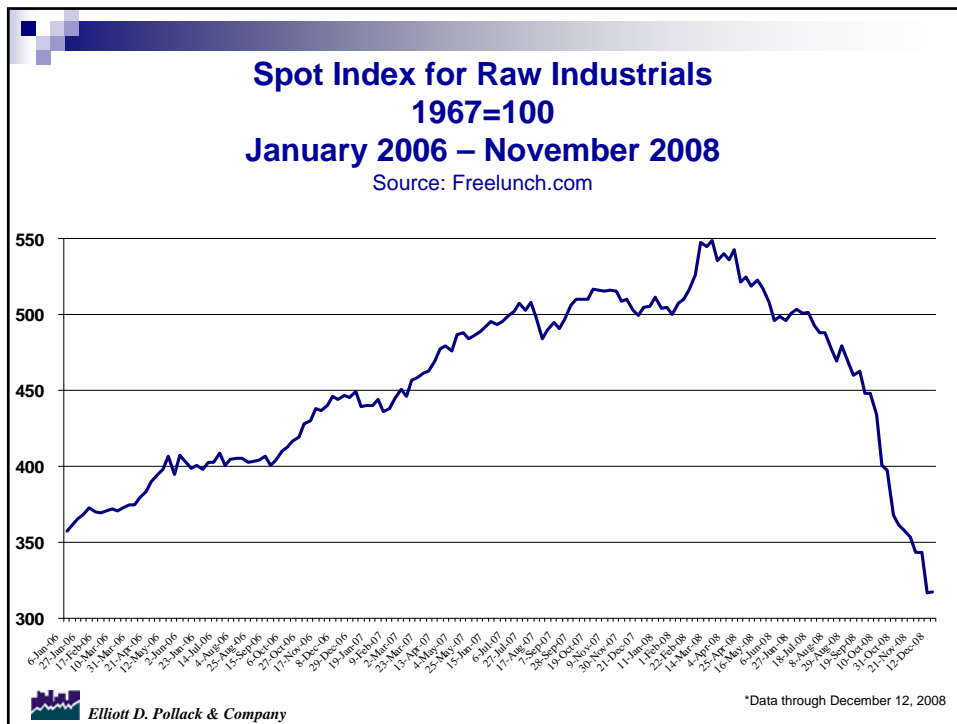
# ?

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## Wealth Effect



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## What Will Happen to HH Net Worth?

### In the 90s

Housing prices increased moderately,  
but stock market boomed.

### First half of 2000's

Stock market was doing poorly,  
but housing prices boomed.

### Now

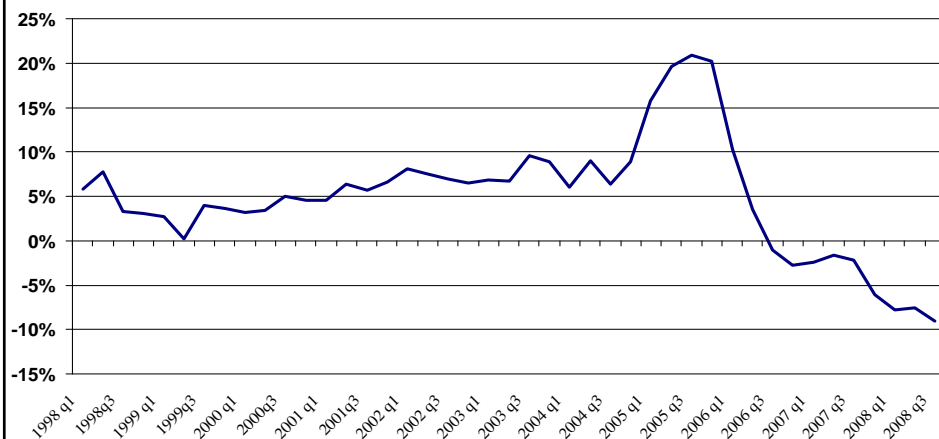
Declining housing prices AND  
poor results in the stock market.



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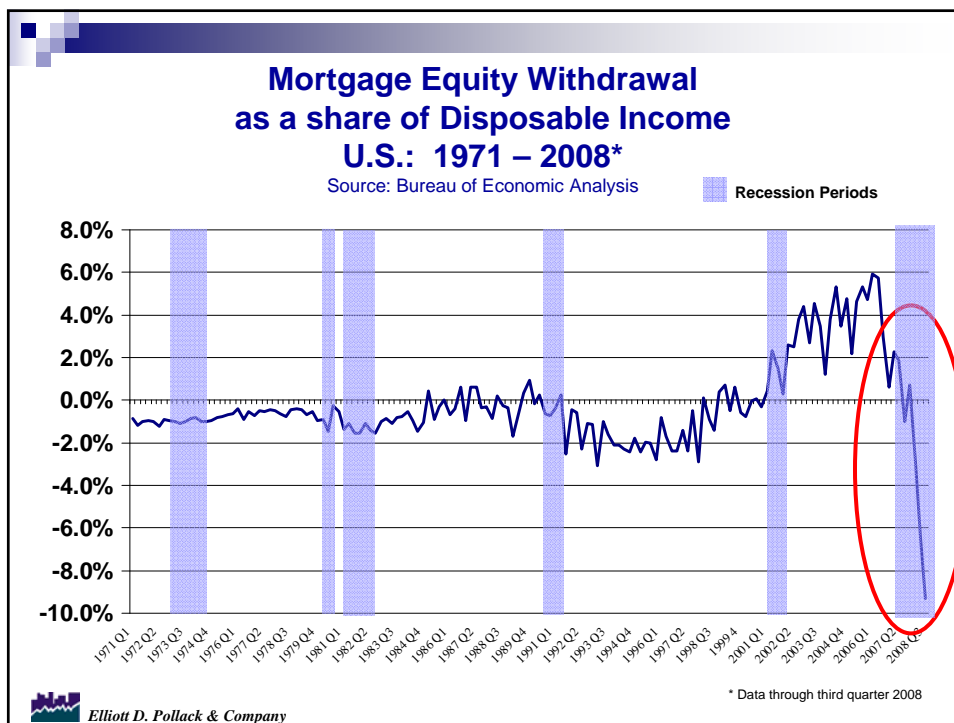
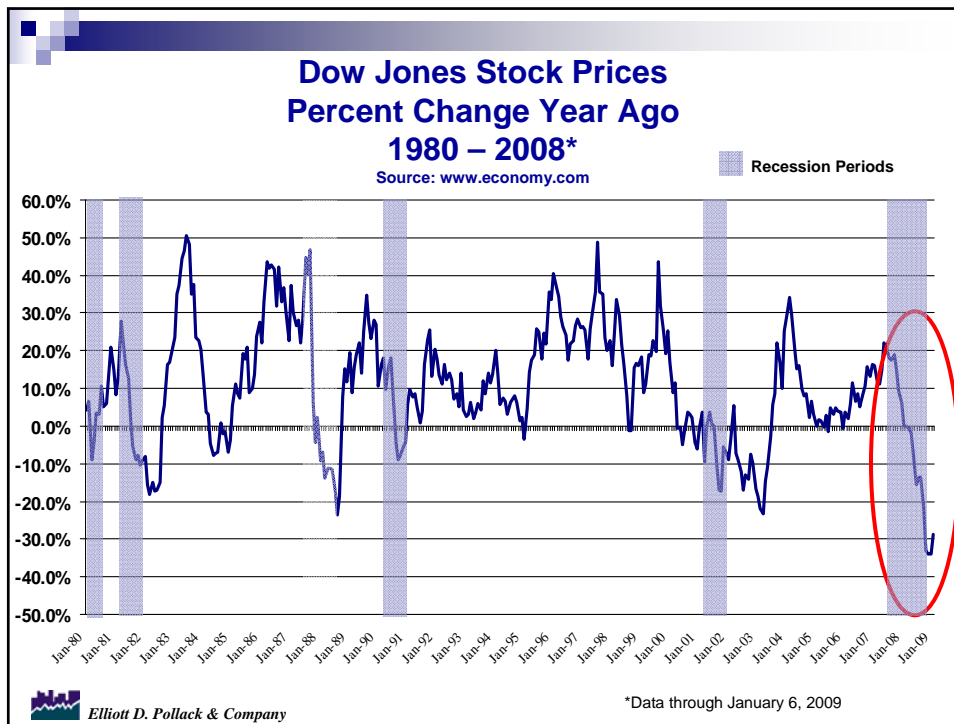
## Median Price of Resale Homes – U.S. Percent Change Year Ago 2003 – 2008\*

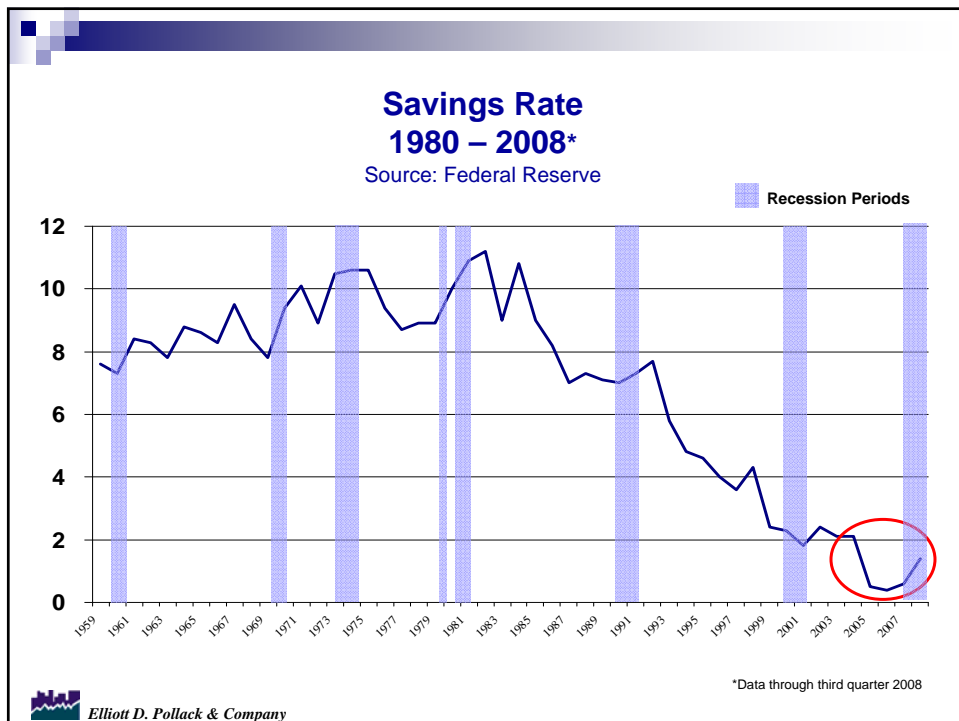
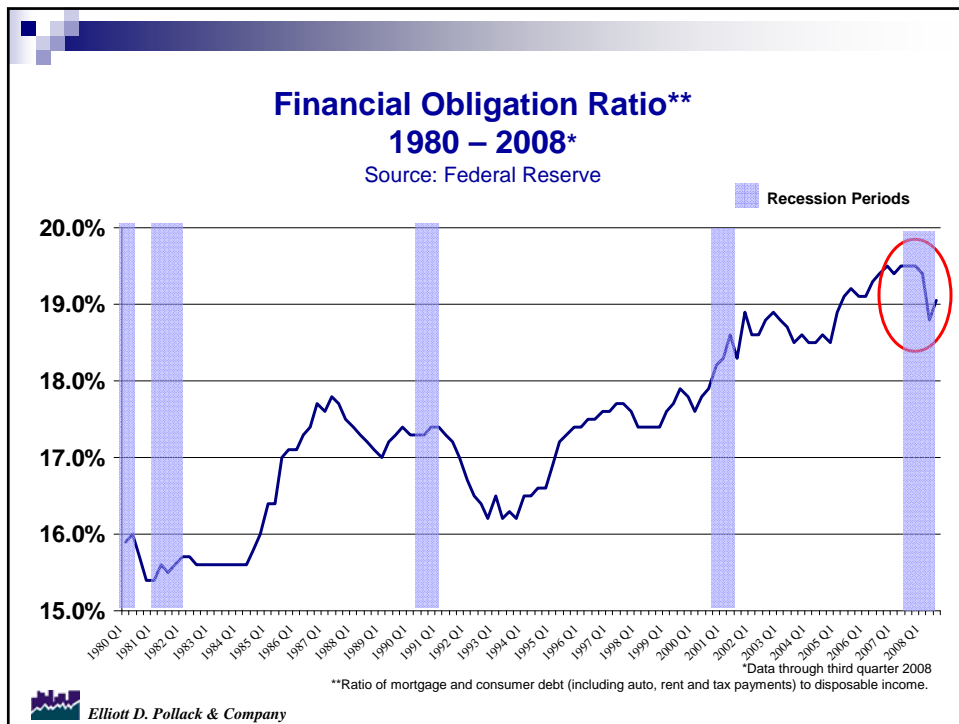
Source: National Association of Realtors



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\*Data through third quarter 2008





## **Business: Finally taking it on the chin?**



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## **The extent depends on the industry...**




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# Saving Graces



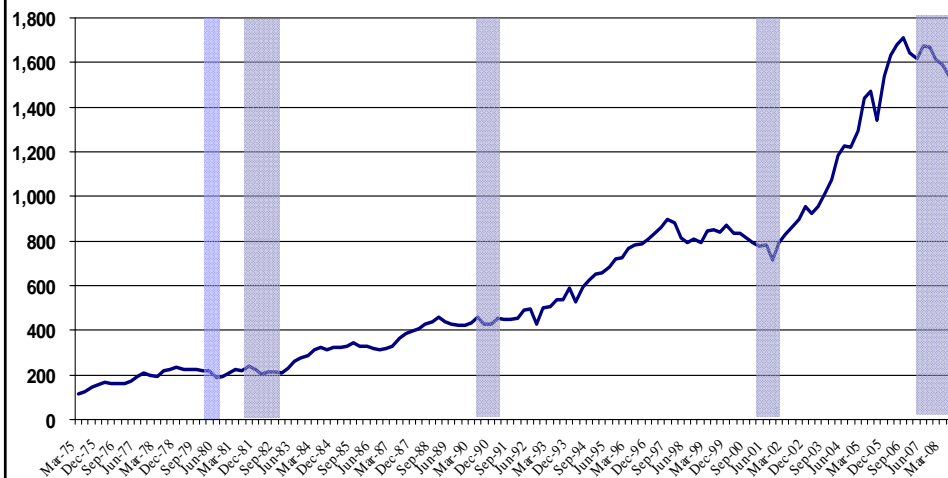
- Corporations were in good financial shape.
- Exports were booming.

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**Corporate Profit**  
(Billions of Dollars, SA)  
1975-2008\*

Source: Freelunch.com

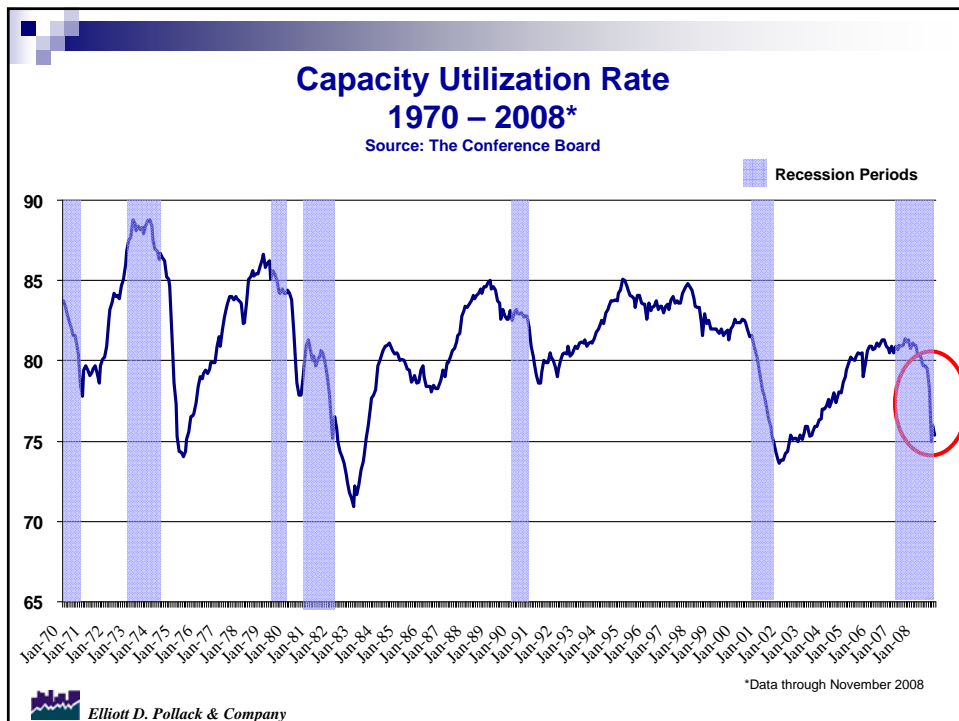
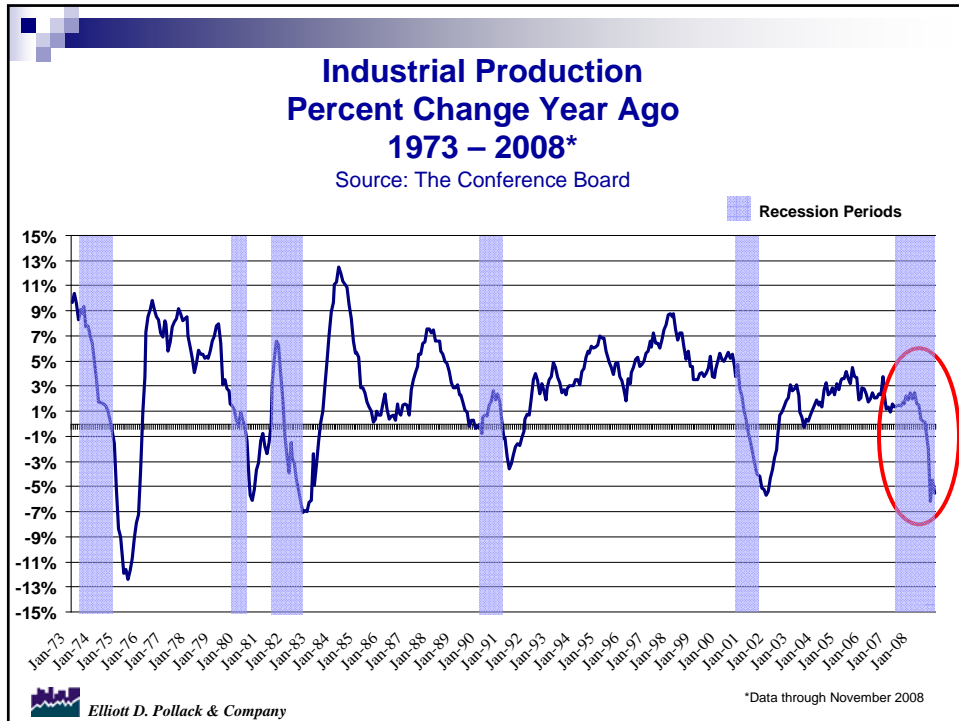
 Recession Periods

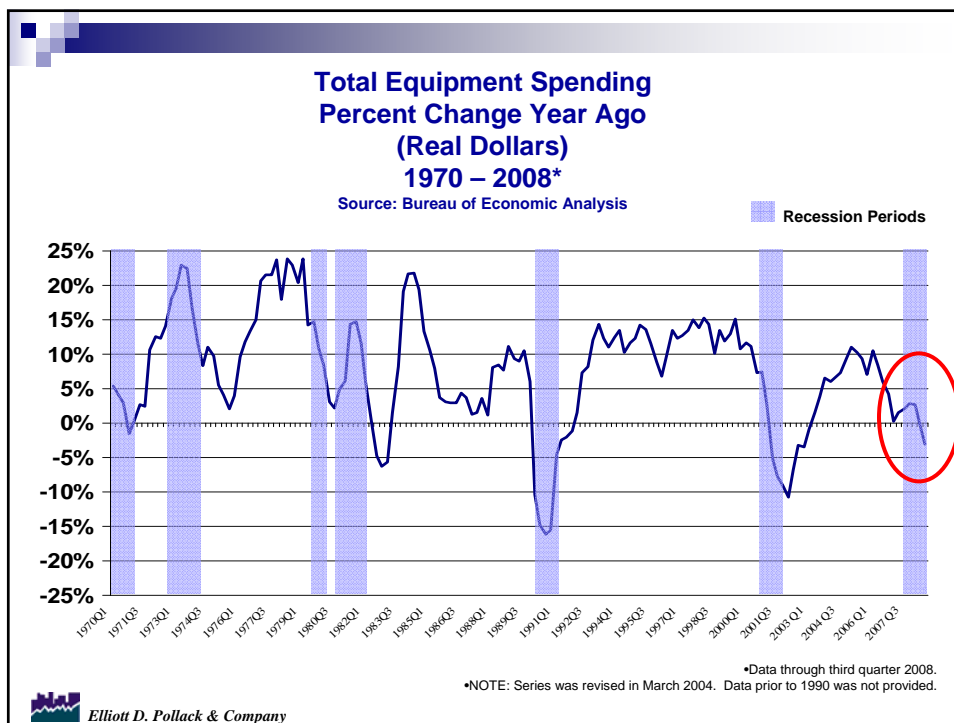
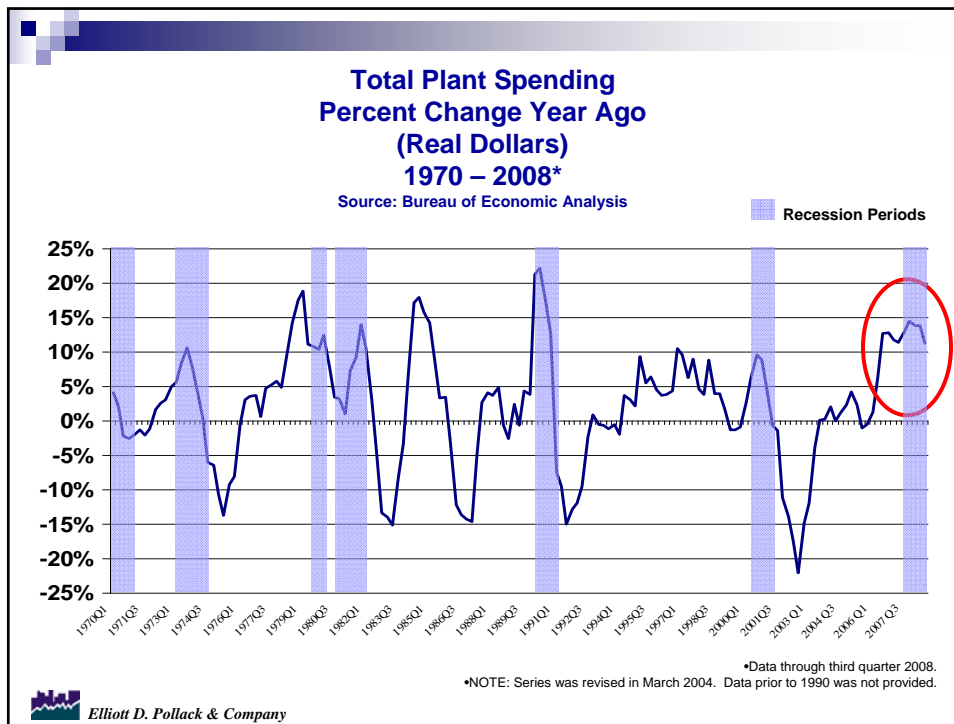


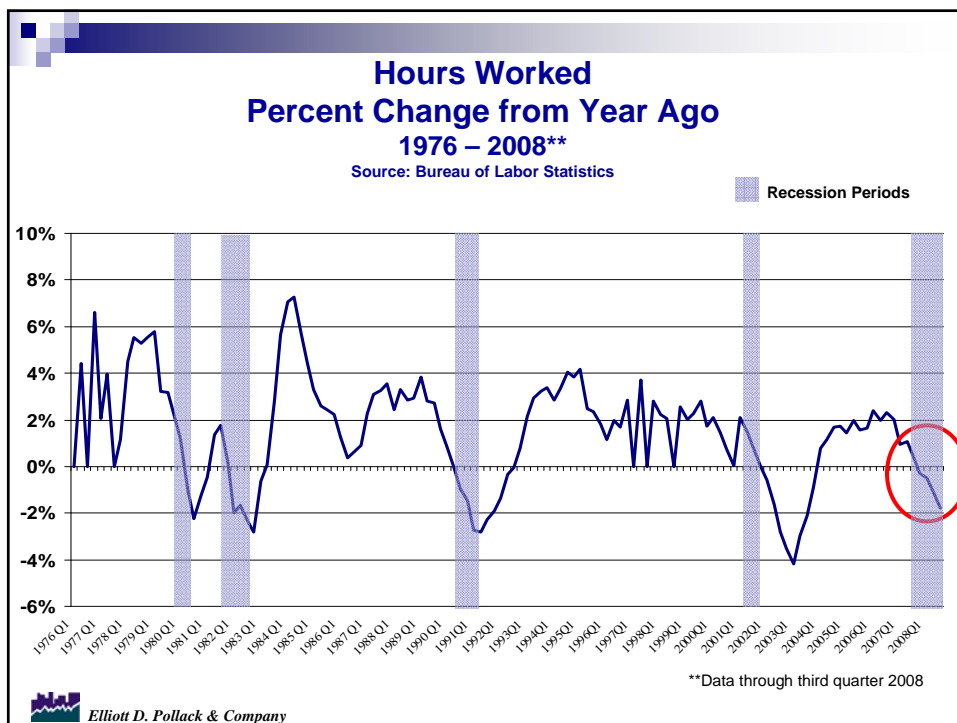
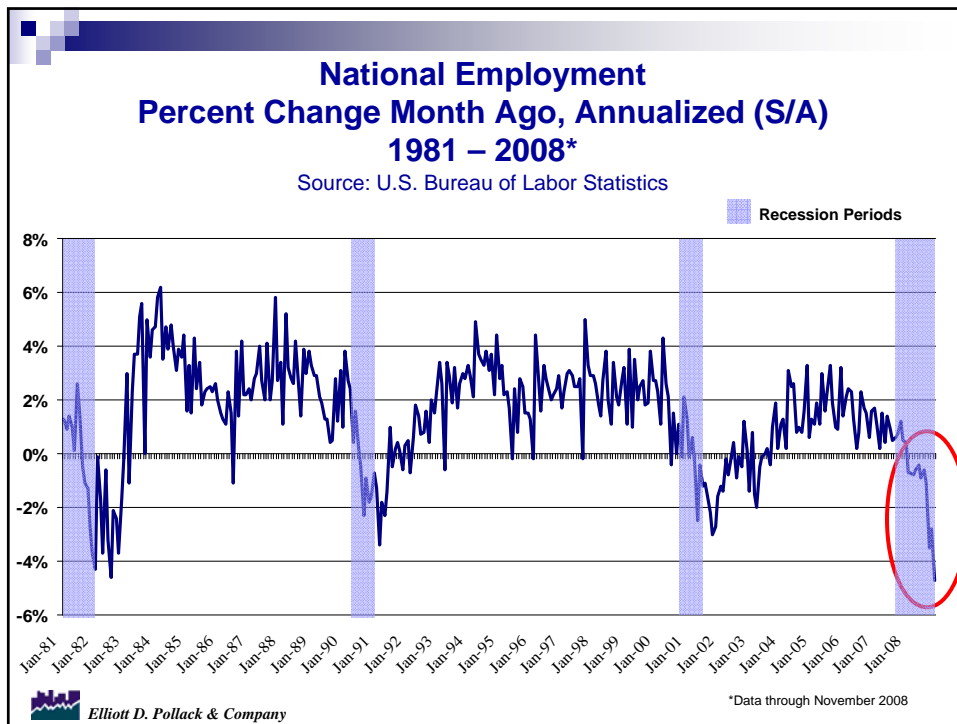
\*Data through third quarter 2008

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# Value of the dollar...

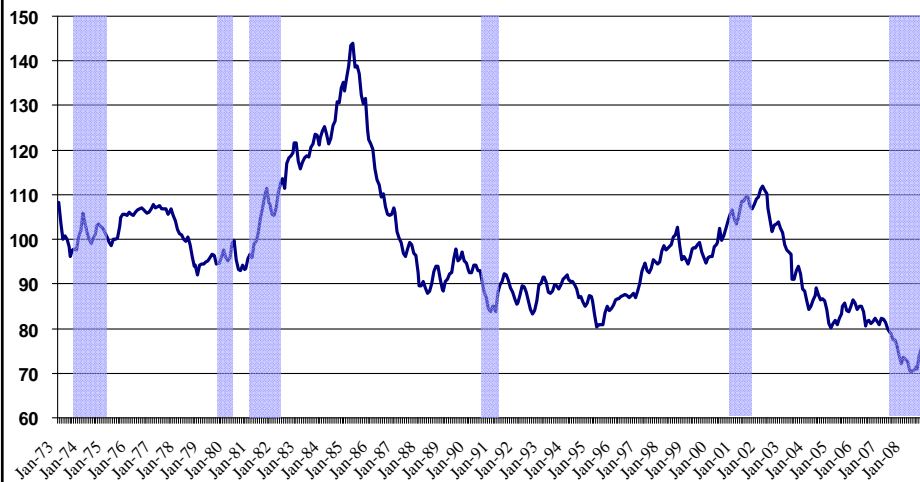


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## US Dollar Trade Weighted Exchange v. Major Currencies (1973 = 100) 1973 – 2008\*

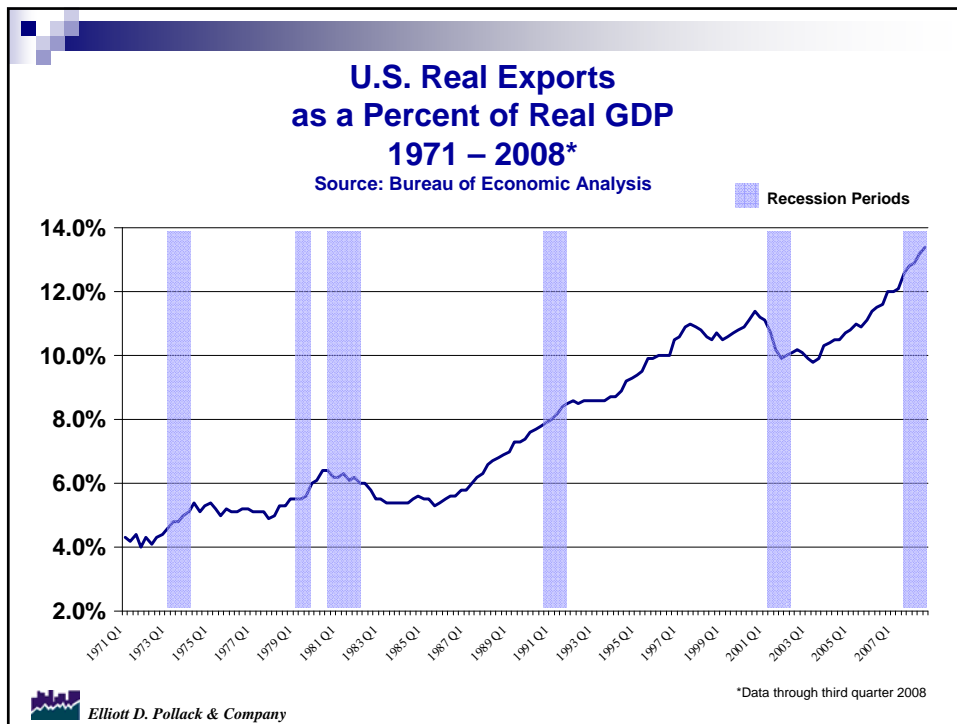
Source: The Federal Reserve

 Recession Periods



\*Data through December 2008

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## Tougher Mortgage Loan Standards

Source: Federal Reserve Survey, October 2008

- 100% of banks tightened on sub-prime mortgages.
- 89.6% of banks tightened on “non-traditional” mortgages  
(ARMs, Interest-only, or Limited Income Verification loans).
- 71.0% of banks tightened on prime mortgage loans.

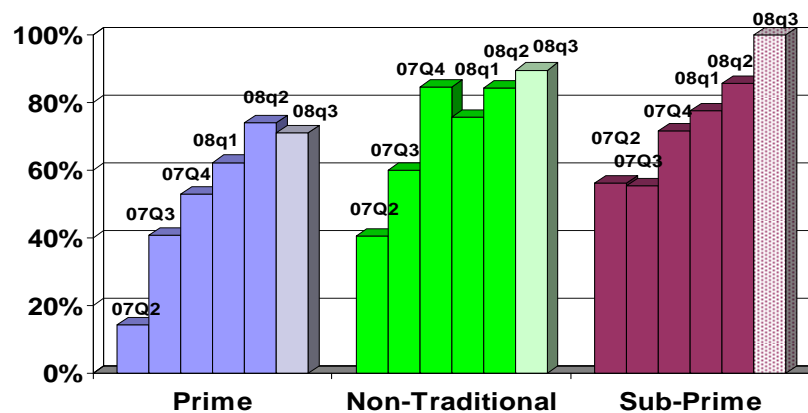


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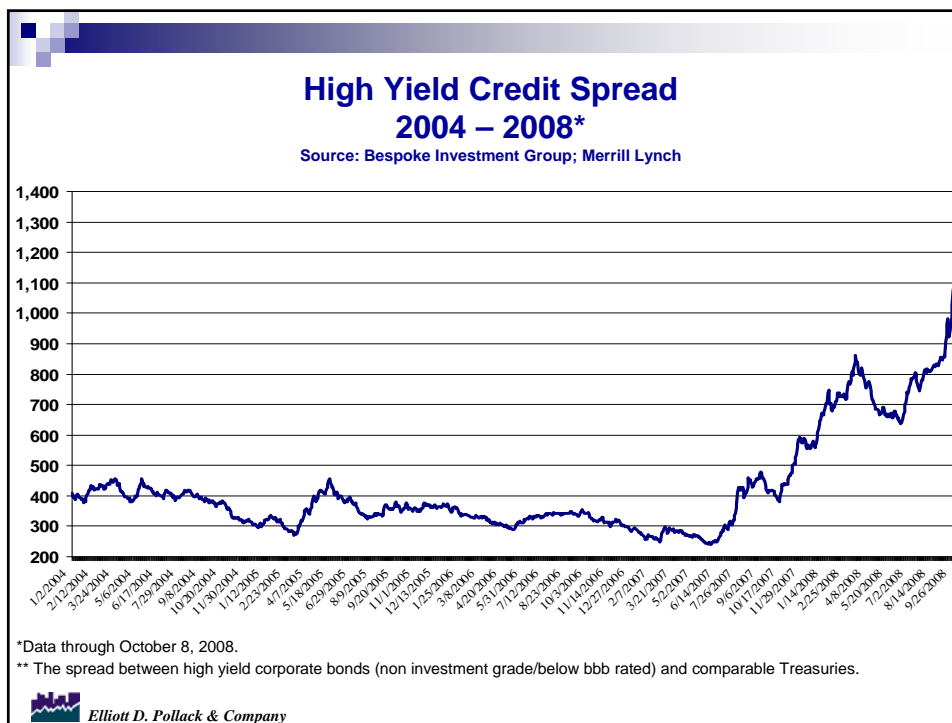
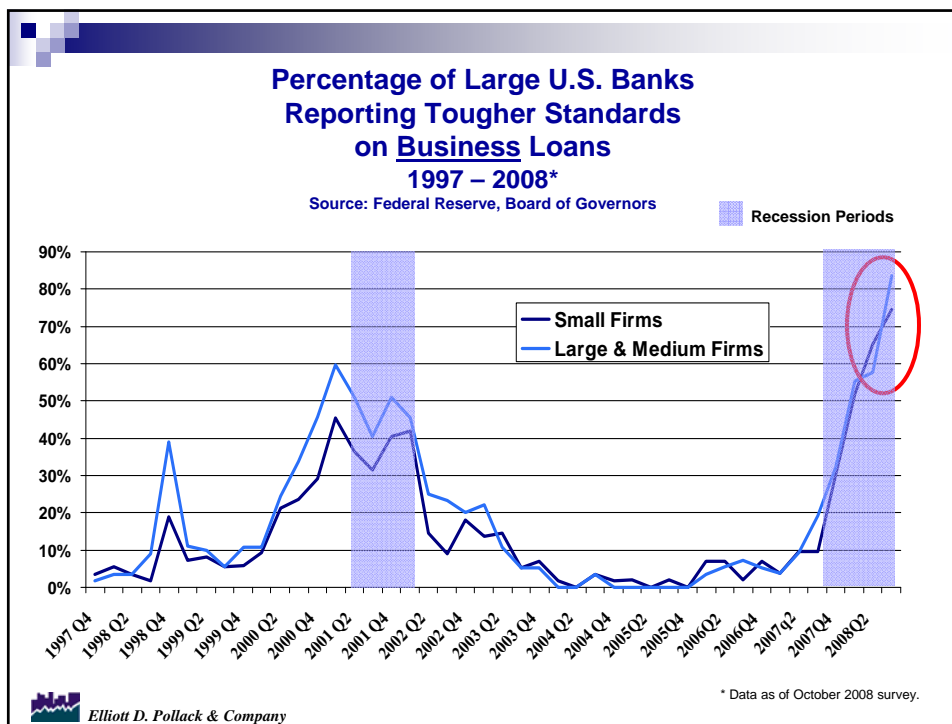
### Net Percentage of Large U.S. Banks Reporting Tougher Standards versus Eased Standards on Residential Mortgage Loans

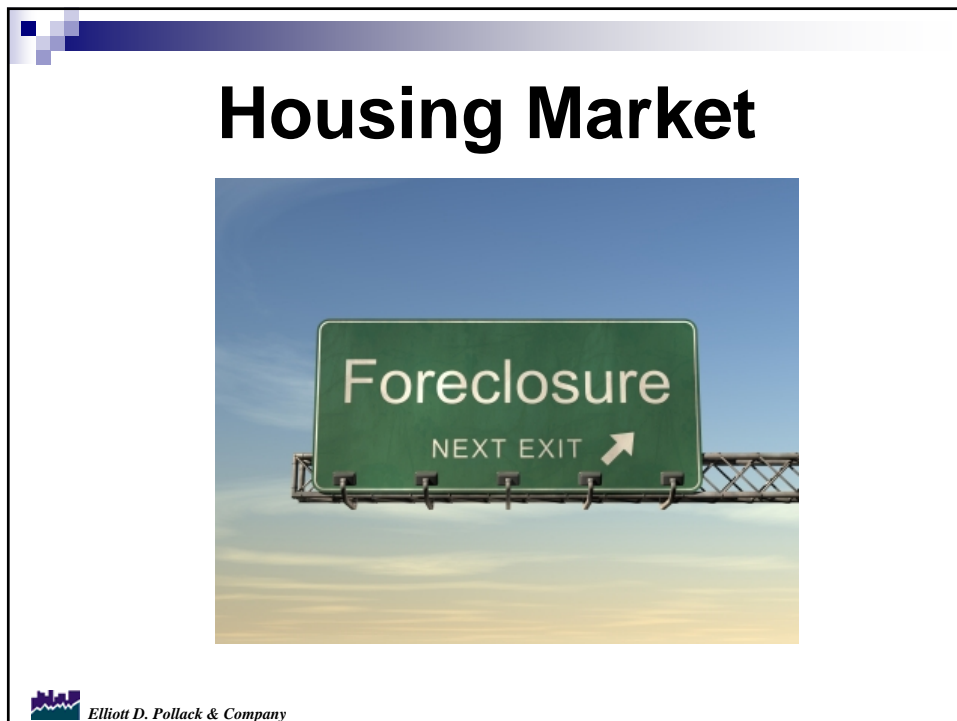
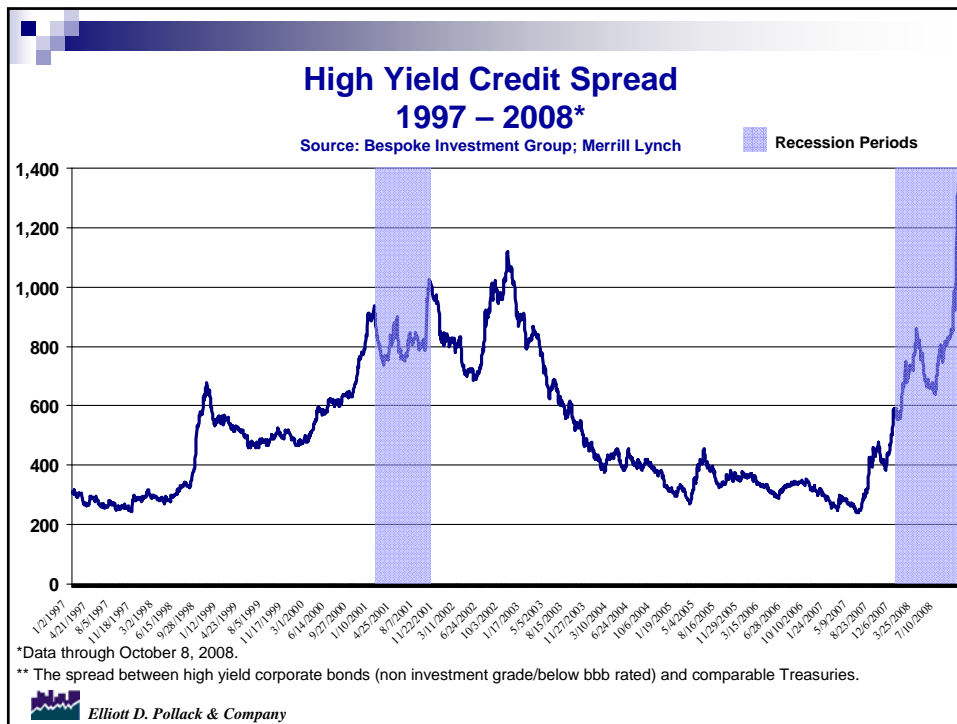
2007 – 2008q3

Source: Federal Reserve, Board of Governors

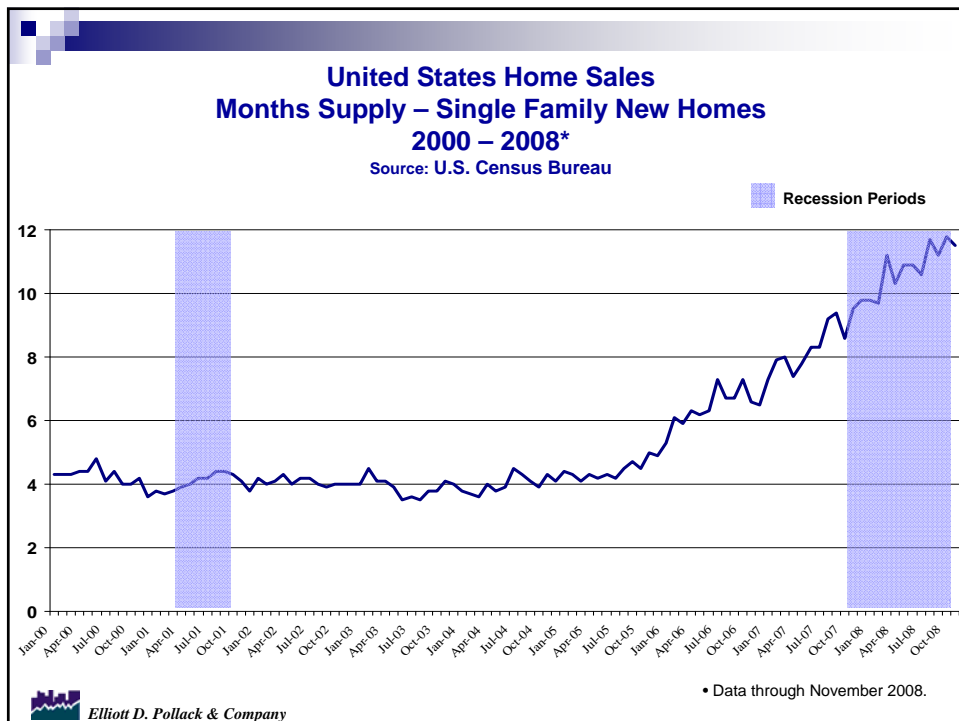
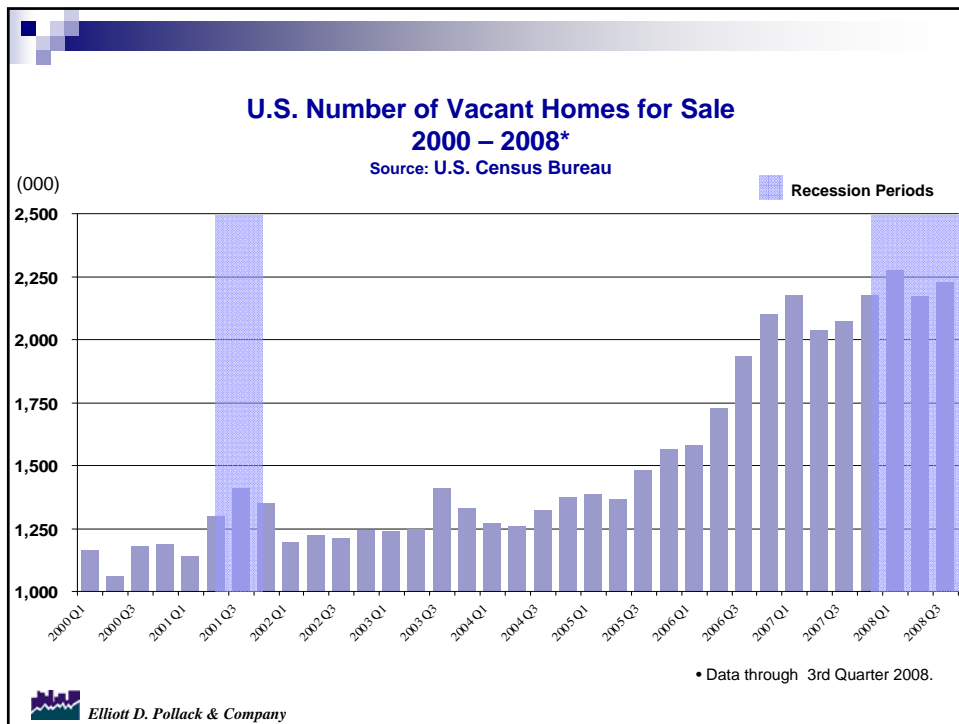


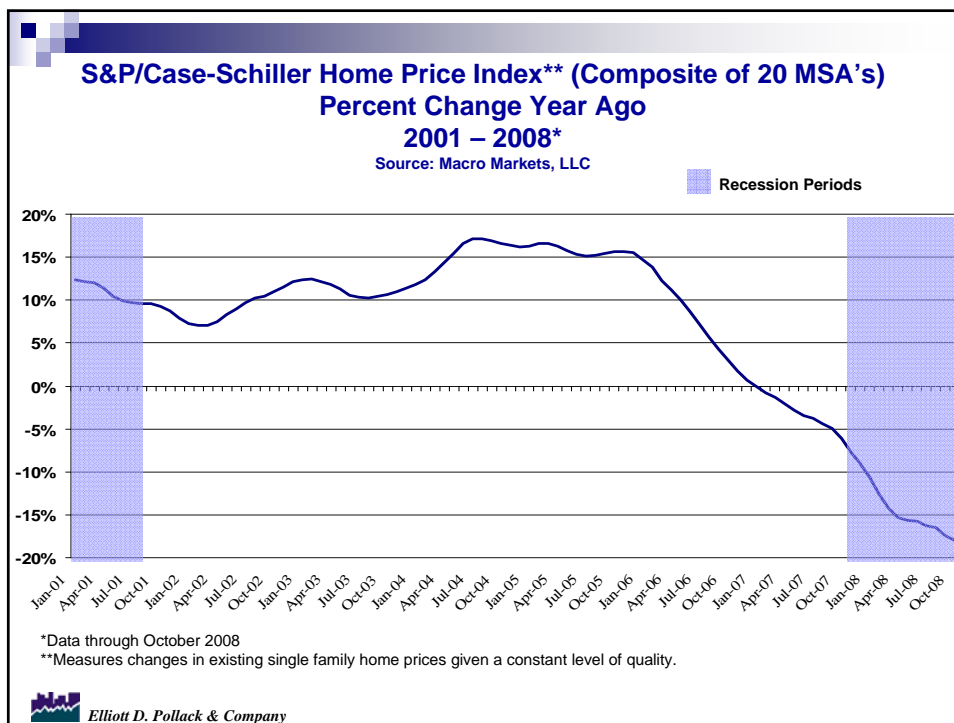
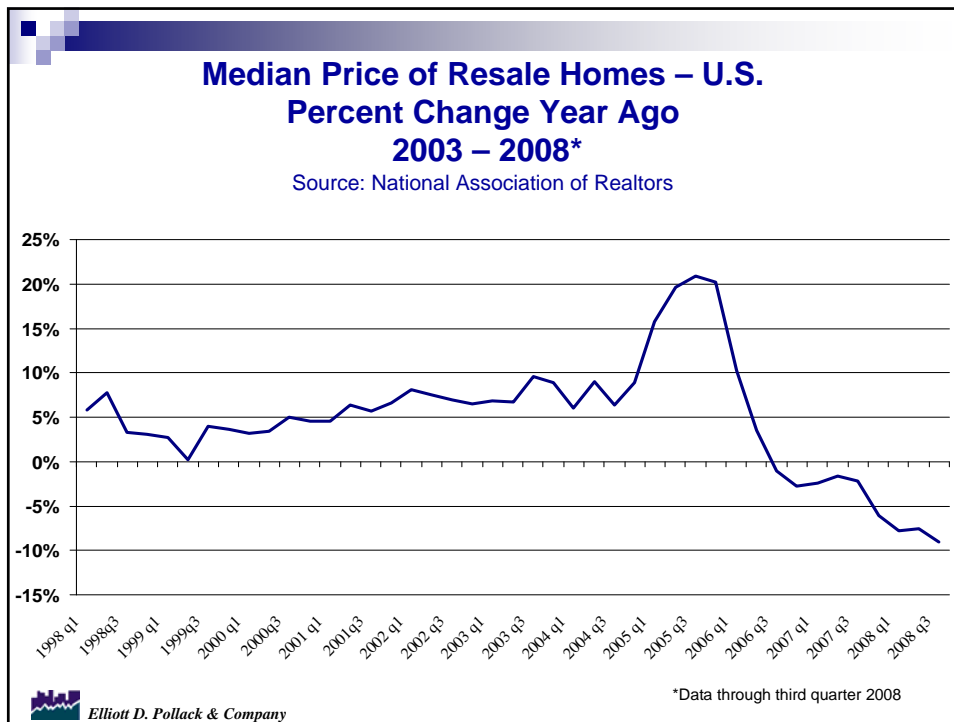
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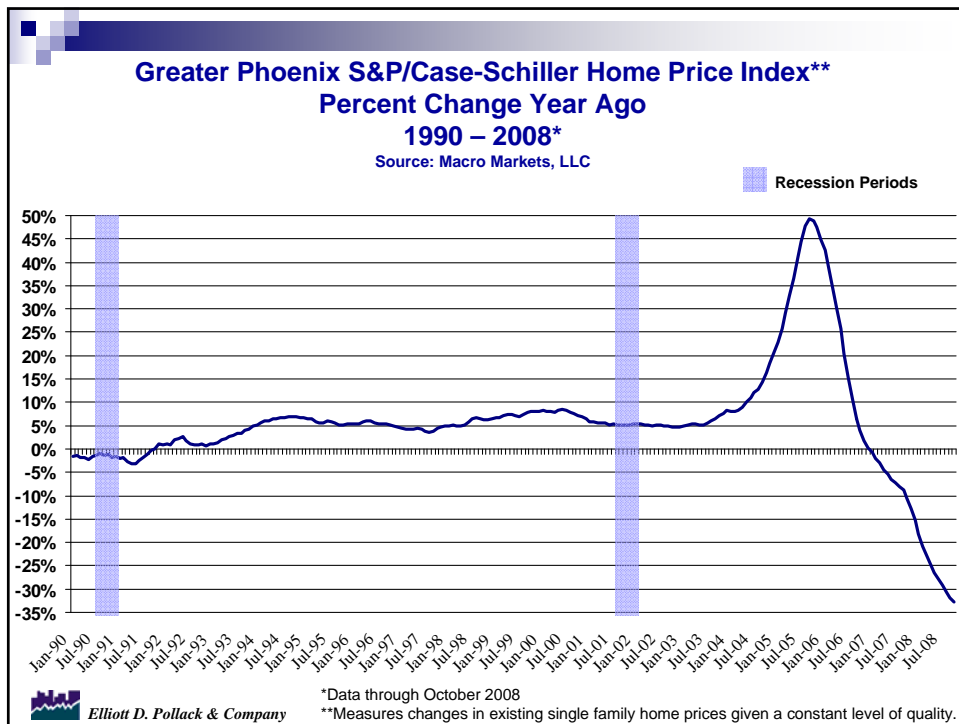


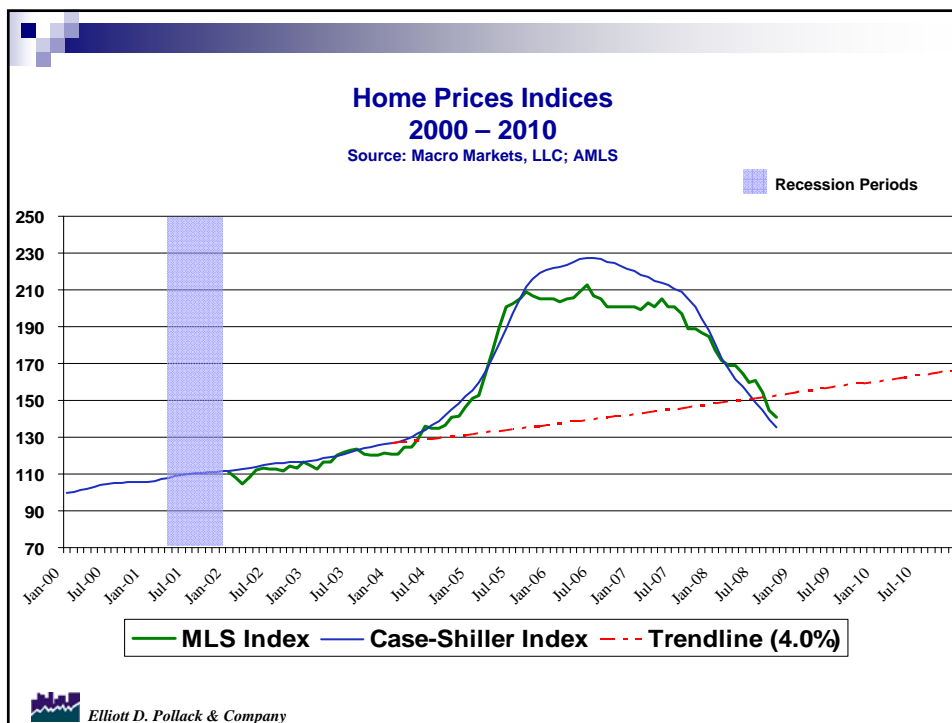
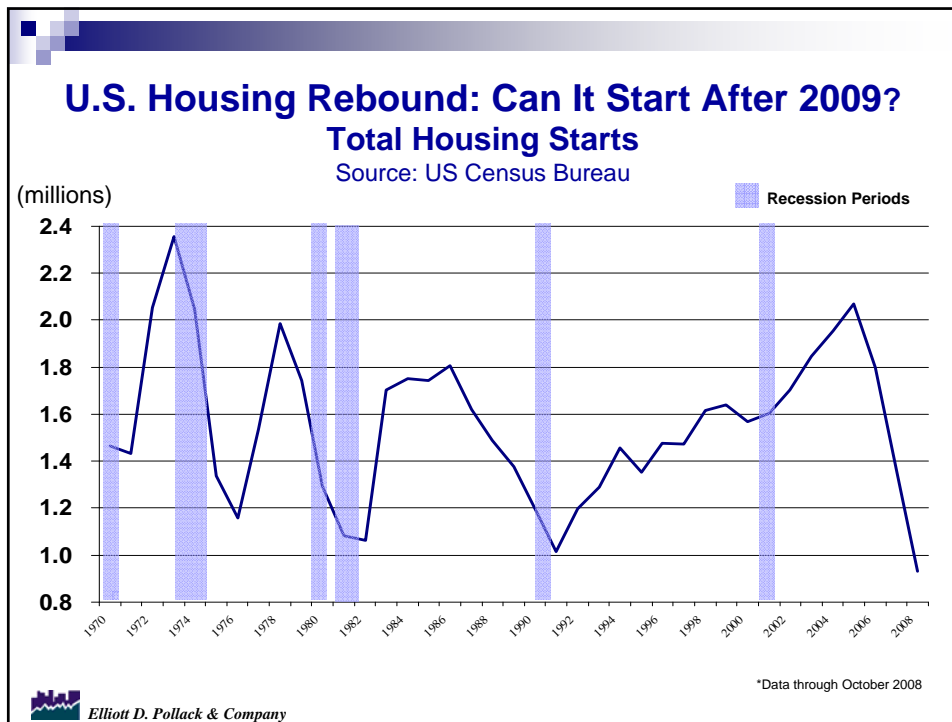















**Tighter lending standards  
and a weak economy  
have acted as a drag on the  
housing market.**



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**Over the past 12 months in the U.S.:**

- 33.3% of homes sold were sold at a loss.
- 18.6% of home sales were foreclosures.

**Of the homes purchased over the past  
5 years, an average of 31.1% have negative  
equity.**

Source: Zillow



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**Over the past 12 months in Greater Phoenix:**

- 48.9% of homes sold were sold at a loss.
- 37.9% of home sales were foreclosures.

**Of the homes purchased over the past 5 years, an average of 41.8% have negative equity.**

Source: Zillow



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## **U.S. Summary 2009:**

**The first half, continued  
ugly.**

**The second half, no better than  
homely.**



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**Because....**

**In the first half, comparisons  
are **tough**.  
In the second half, comparisons  
get easier.**



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*Economic and Real Estate Consulting*

**WWW.ARIZONAECONOMY.COM**

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**7505 East Sixth Avenue, Suite 100 Scottsdale, Arizona 85251**  
**480-423-9200 P      480-423-5942 F      [www.arizonaeconomy.com](http://www.arizonaeconomy.com)**



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# Economic Update and Outlook: **Arizona**

Marshall J. Vest  
Eller College of Management  
The University of Arizona

❖ JLBC FAC, January 13, 2009

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## Overview

- The nation's economy is suffering a severe recession
  - Economy in free fall as 2008 came to an end
- Arizona is one of the hardest-hit states
  - No sign of the bottom as yet
- Recession should end in second half,  
followed by slow recovery in 2010

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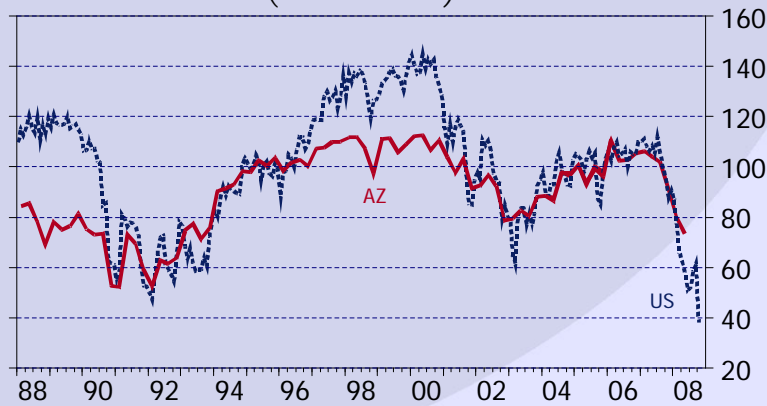
## Consumer Are in Full Retreat

- High gasoline prices have “crowded out” other spending
- In 12 months ending August
  - Gasoline sales up 26%
  - Retail down 8.3%
  - Restaurant & bar sales down 2.1%
  - All three combined, 3.8% lower
- Forecast (all three)
  - 2008 = -2.5%
  - 2009 = -1.6%

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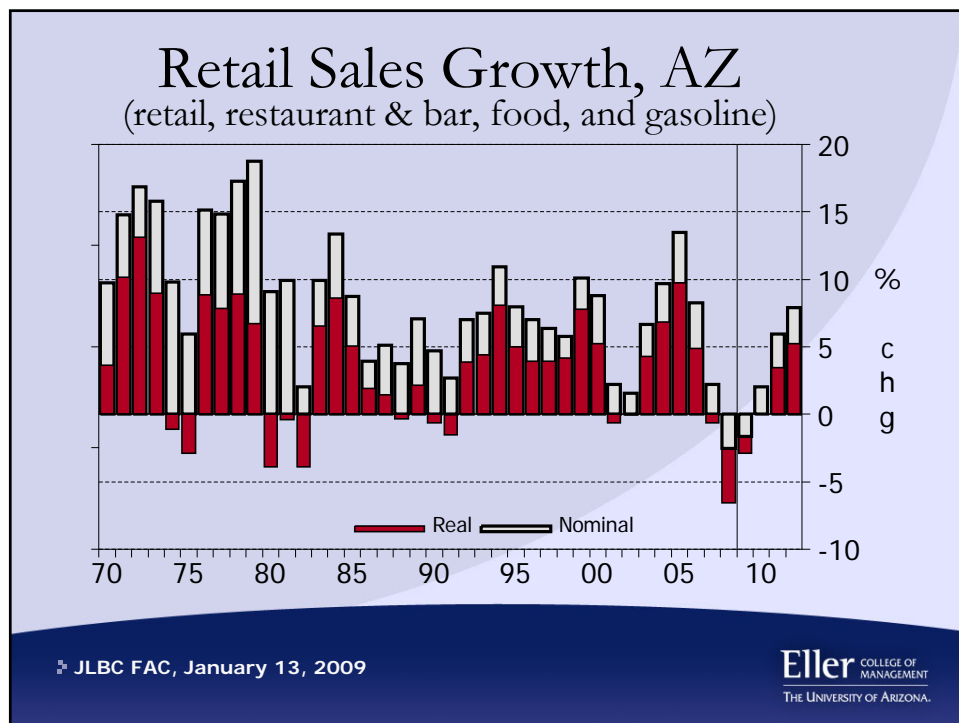
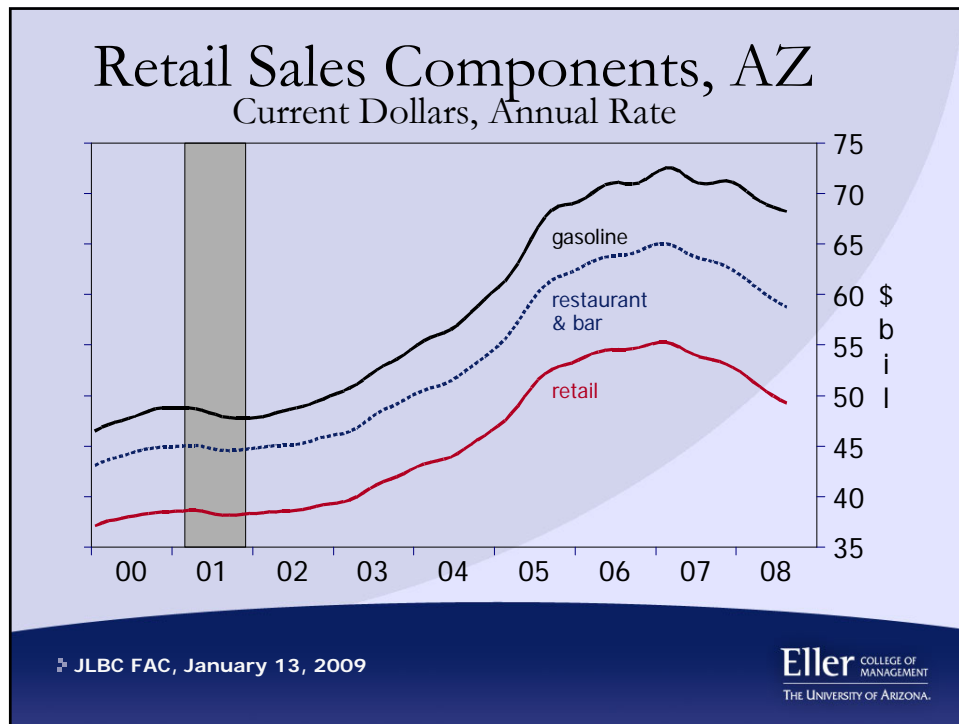
## Consumer Confidence Index (1985=100)



Source: Conference Board and Behavior Research Center, Inc.

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## Arizona Personal Income

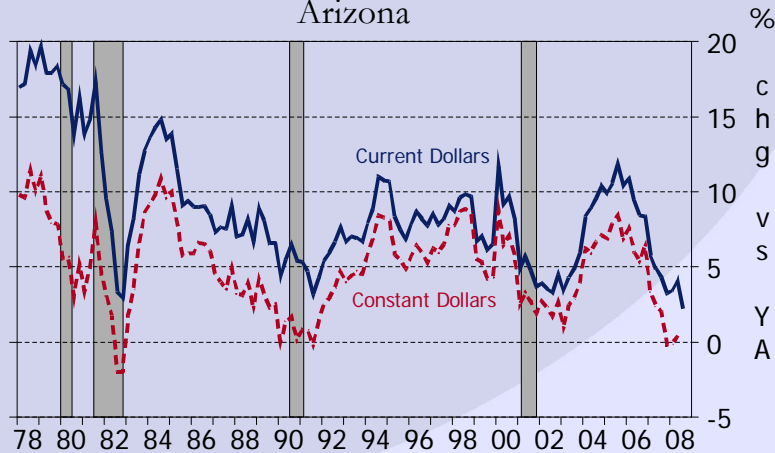
- Increased by 4.5% in 2007
  - 1Q 2008 = 3.4%
  - 2Q = 4.1%
  - 3Q = 2.3%
- Forecast for 2008 = 2.8%
  - 2009 = -0.4%
  - 2010 = 3.1%

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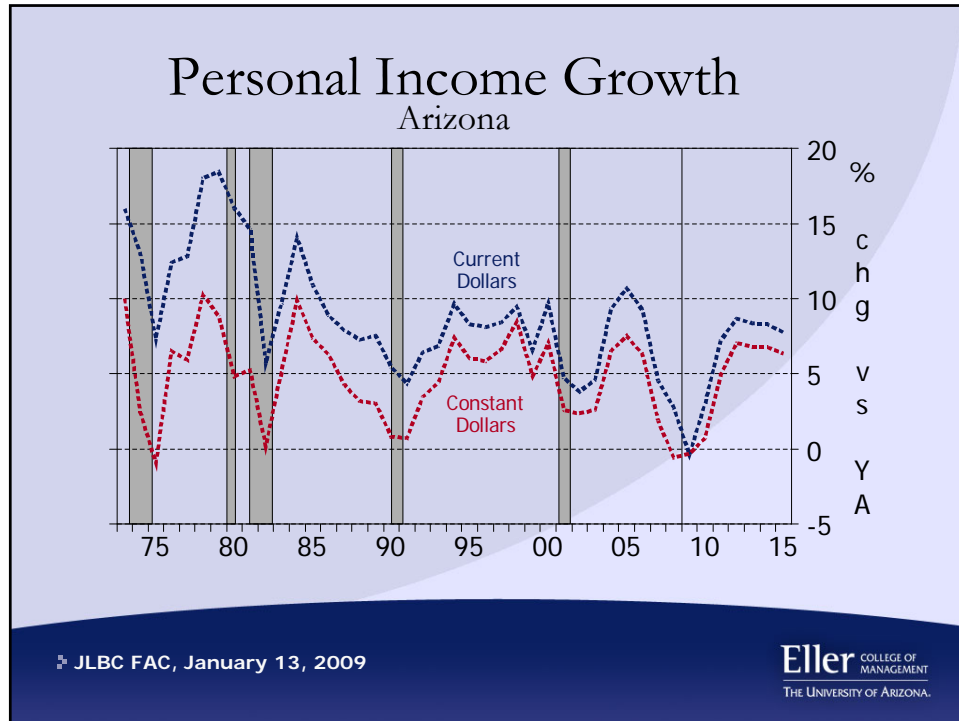
## Personal Income Growth

Arizona



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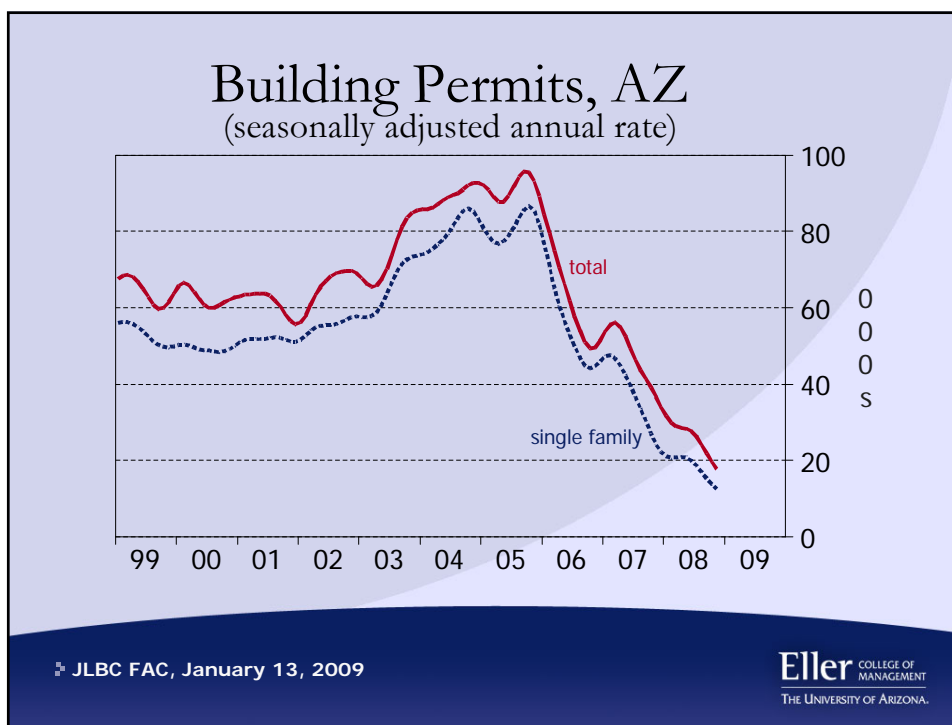
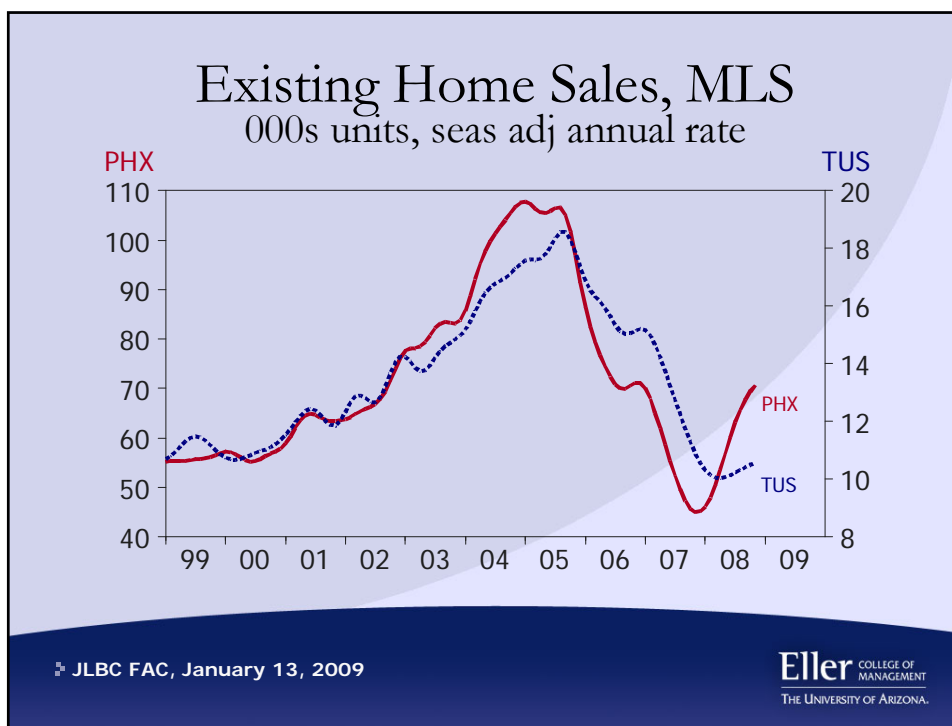


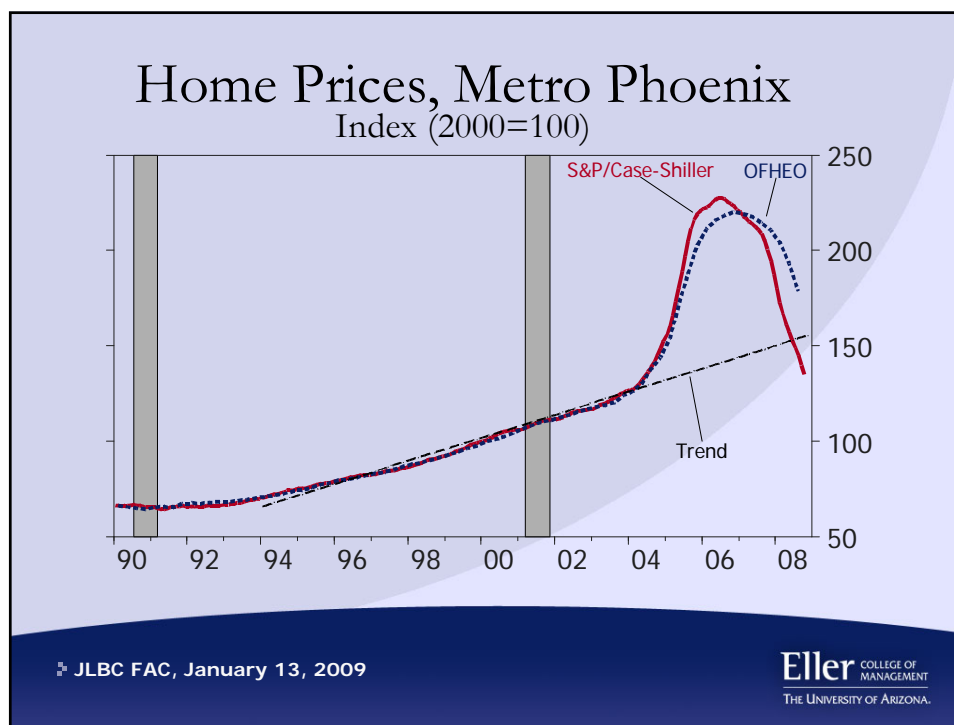
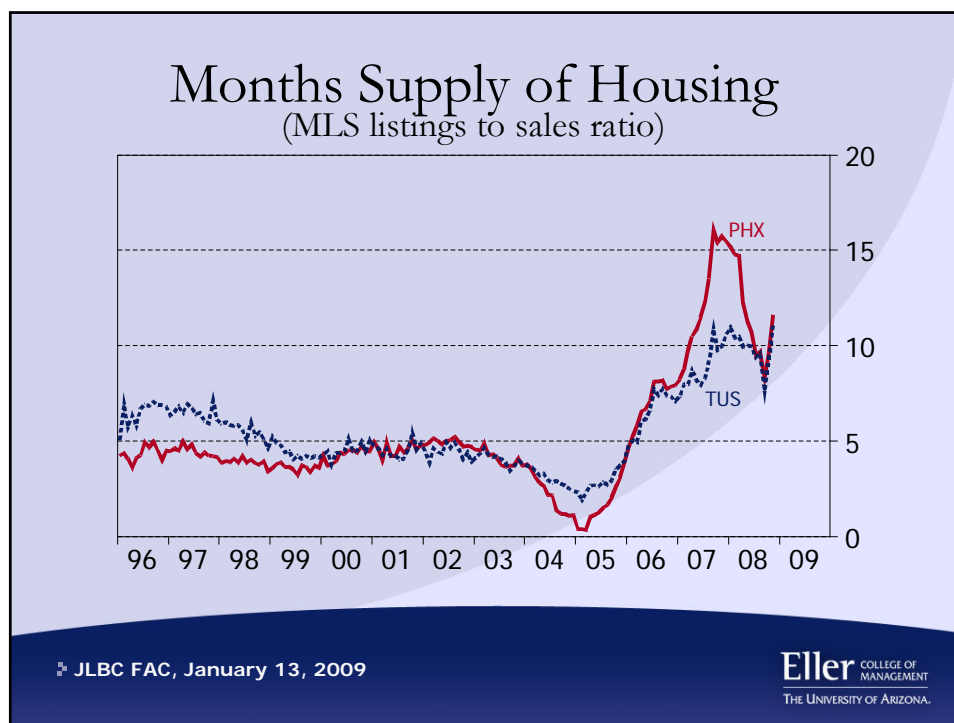
### Housing Update

- Home resales moving higher
  - But foreclosures account for major portion
- Residential permits still declining
  - But nearing bottom
- Inventories still very high
- Housing prices are moving lower

Source: JLBC FAC, January 13, 2009

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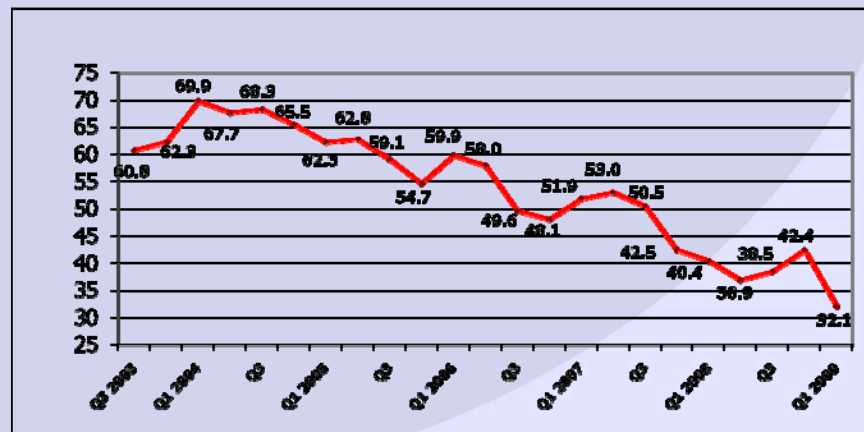
## Labor Market Update

- Business Confidence at recessionary levels
- Nonfarm employment peaked August 2007
  - Lost 83,000 jobs, or 3.1%
- Losses are spread across sectors
- Unemployment rate headed above 8%
  - But will remain below levels in prior recessions
- Nonfarm jobs will decline 70,000 this year
  - Bottom in 4<sup>th</sup> quarter

JLBC FAC, January 13, 2009

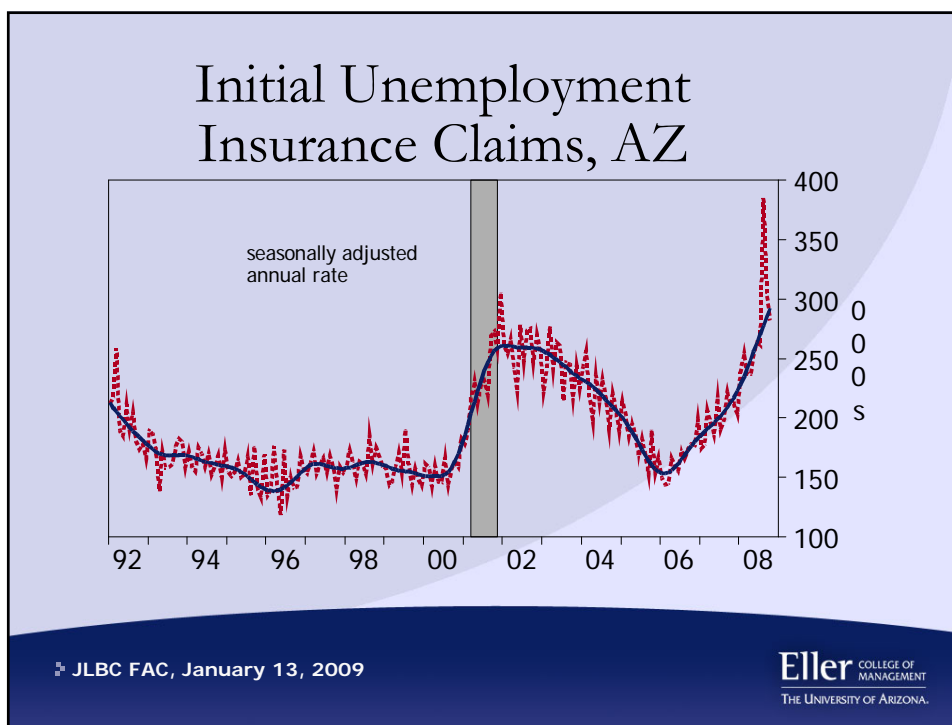
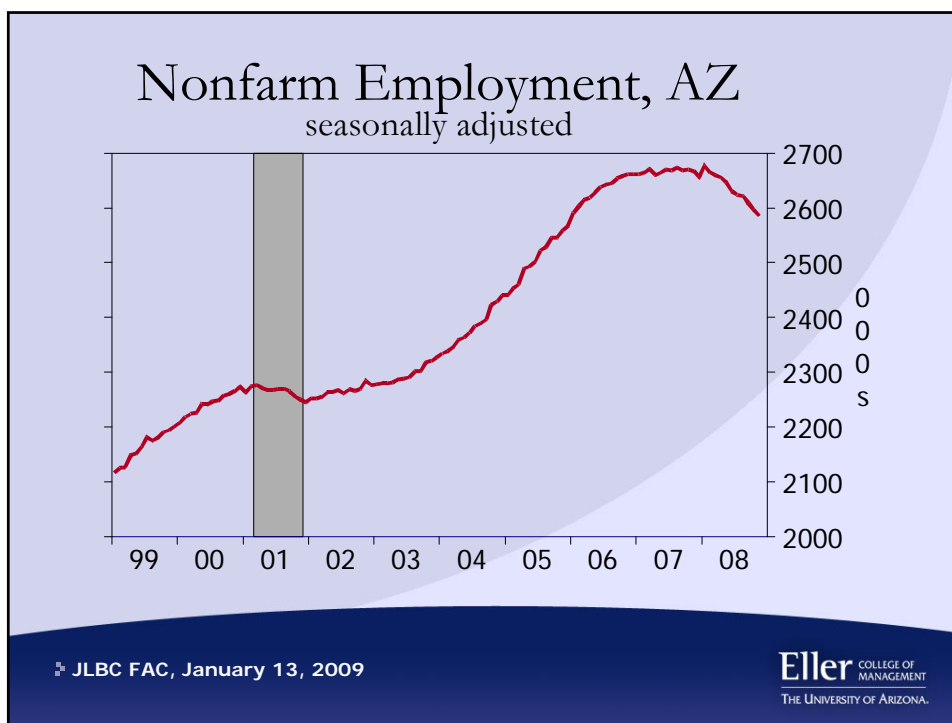
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## Business Leader Confidence Index Arizona

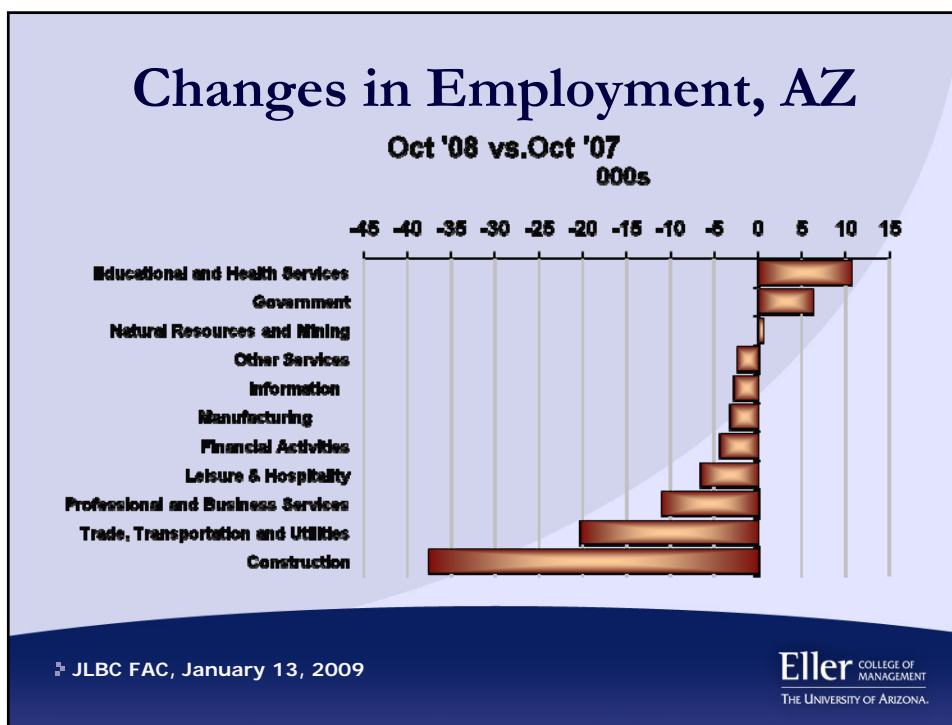
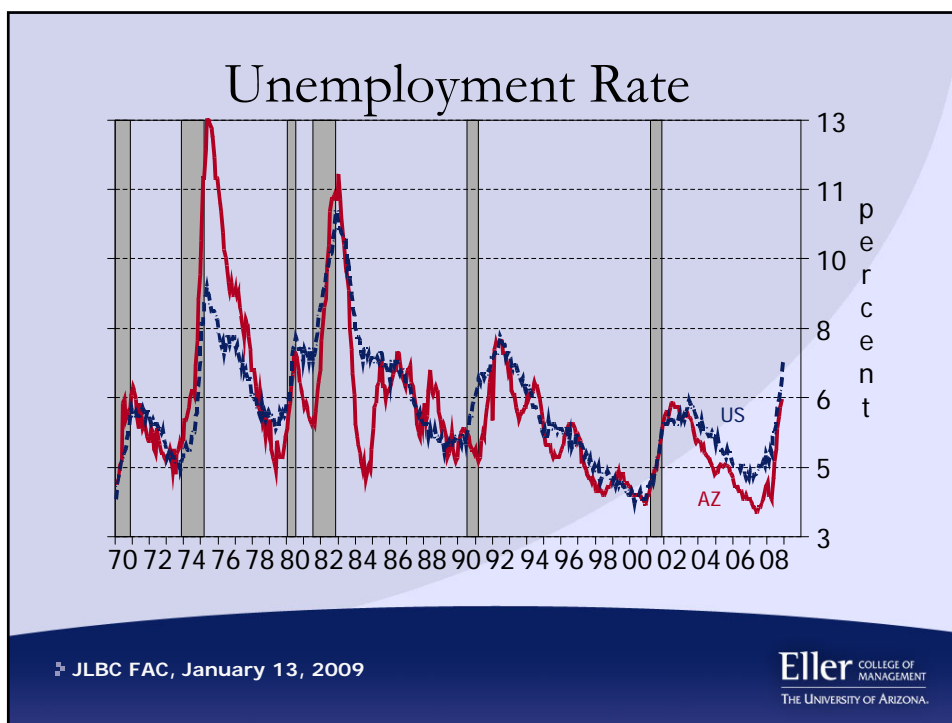


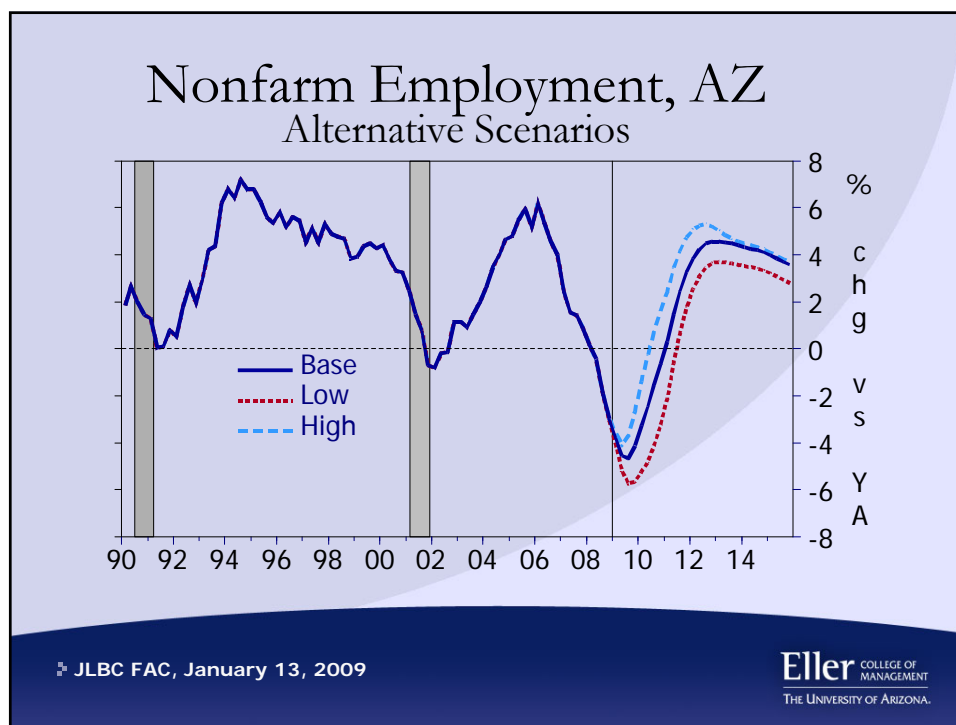
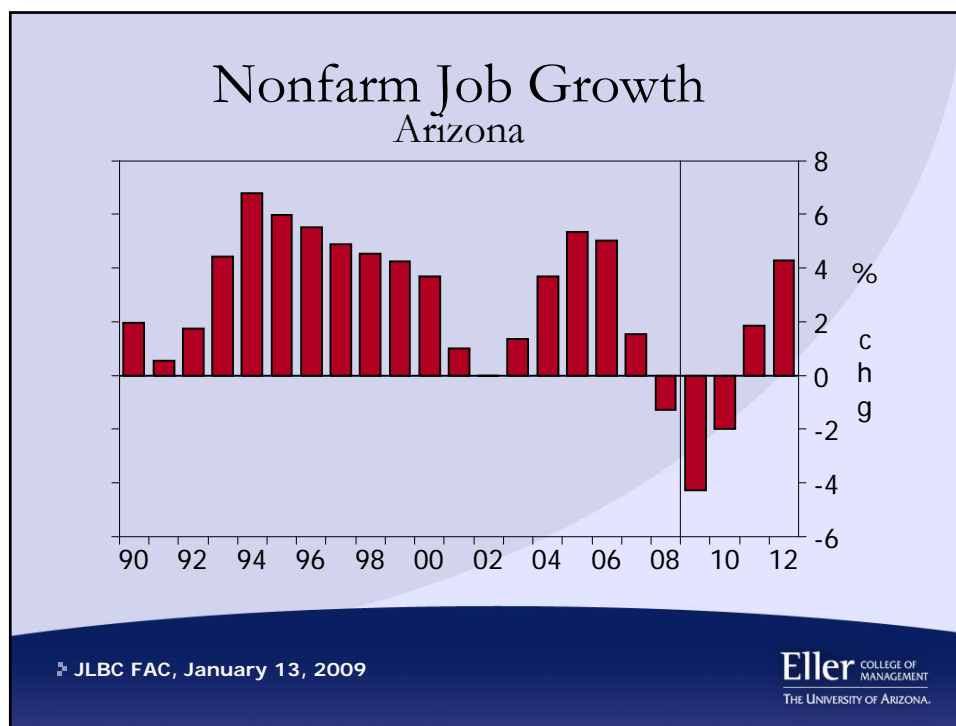
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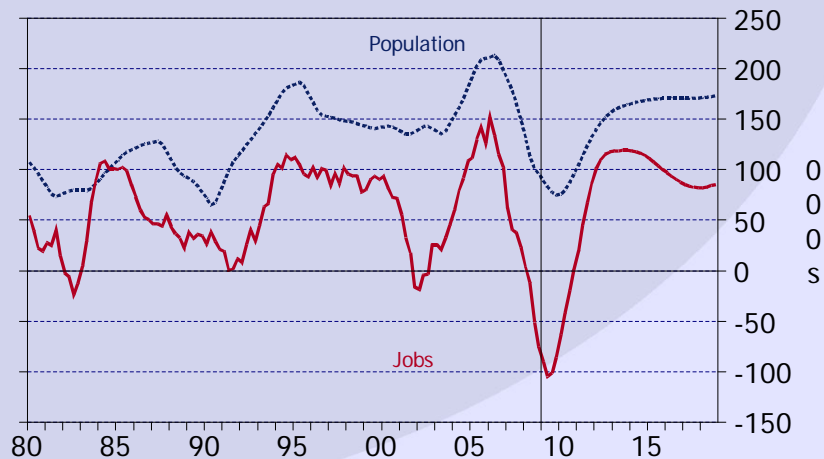
## Population Growth Slowing

- U.S. Census Bureau estimates
  - Mid-year 2008 AZ pop = 6.5 million
    - Up 2.3%, or 147,000
- Currently, growth is probably nearer half that amount
  - 70,000 annual increase, or 1.2%

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## Annual Change in Pop & Jobs Arizona



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## Indicators To Watch

- Initial unemployment insurance claims
- Auto sales
- Nonfarm employment
- Consumer and business confidence
- Financial markets
  - Stock market indexes
  - Yield spreads
- Price levels

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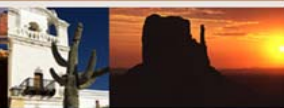
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# *State Budget & Cash Flow Crisis*



January 13<sup>th</sup> 2009

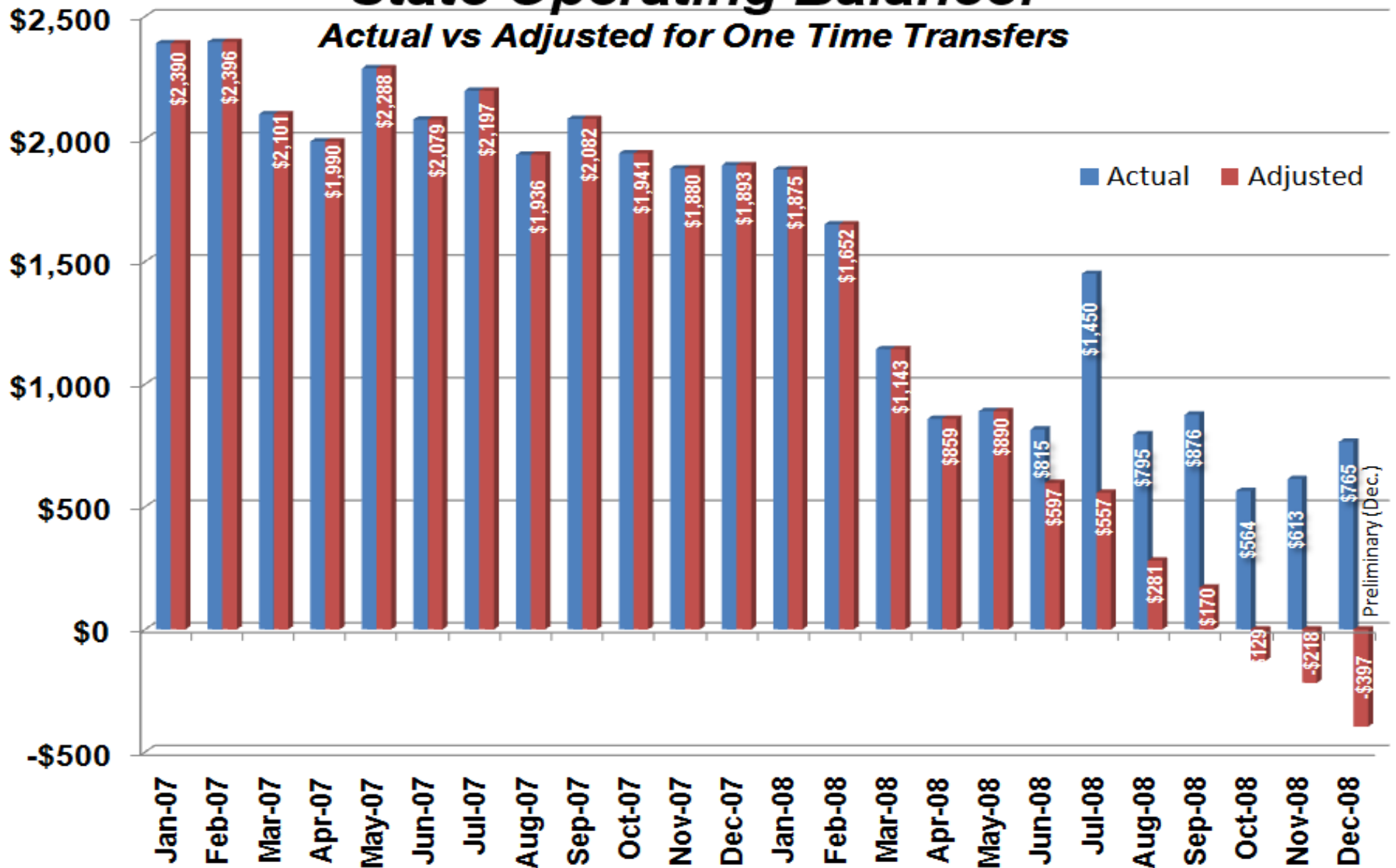


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# State Operating Balance: Actual vs Adjusted for One Time Transfers

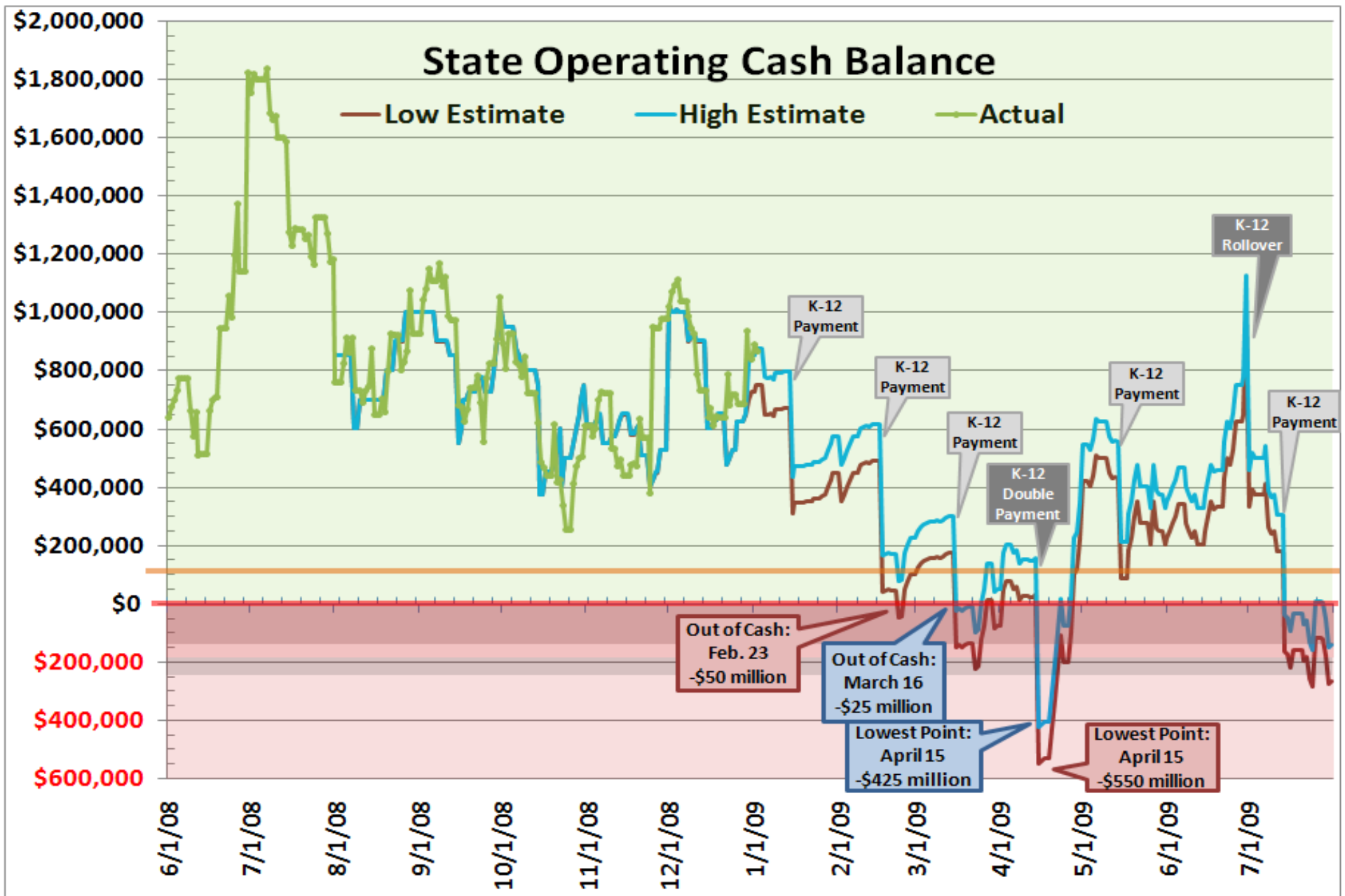


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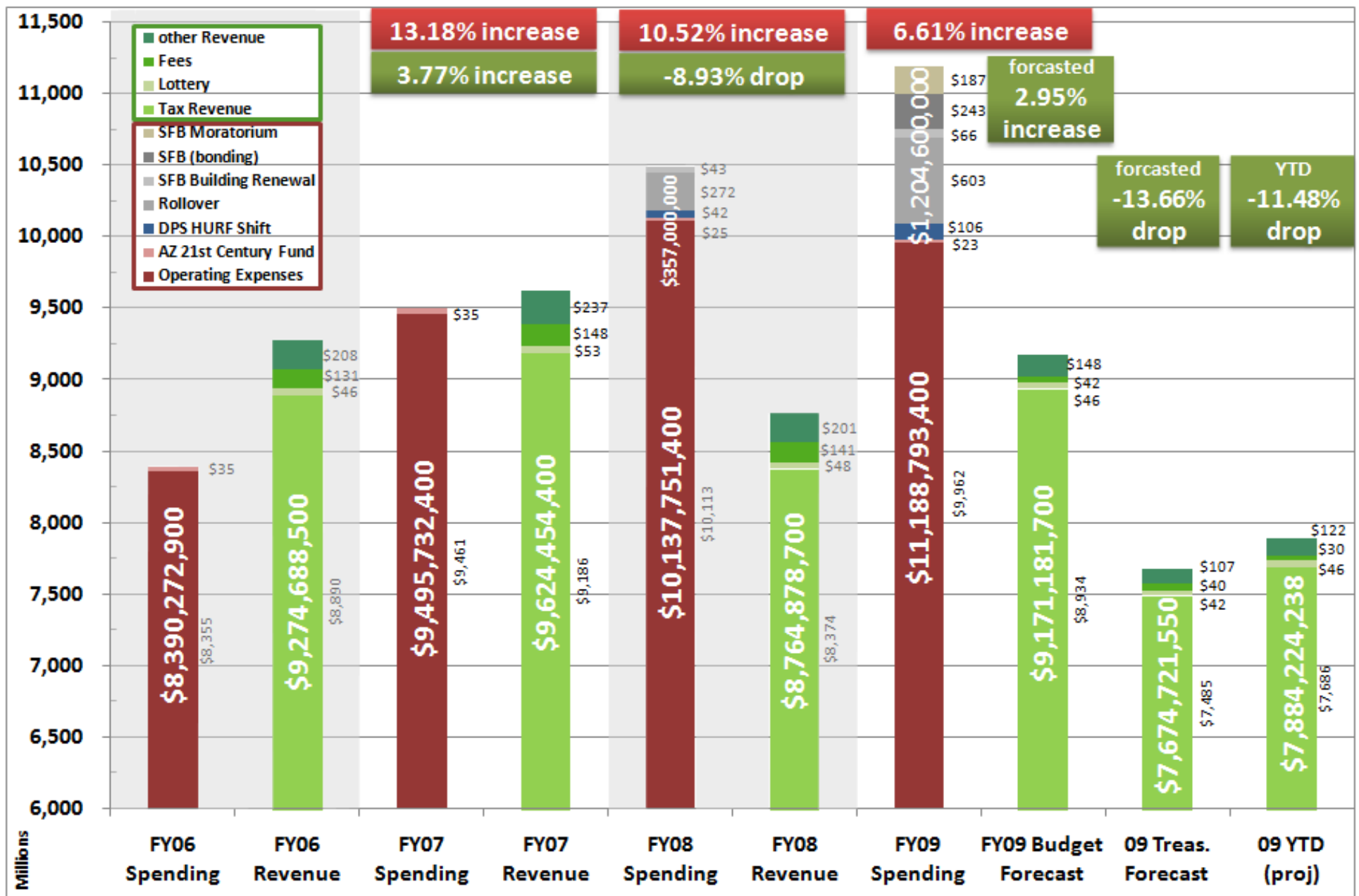
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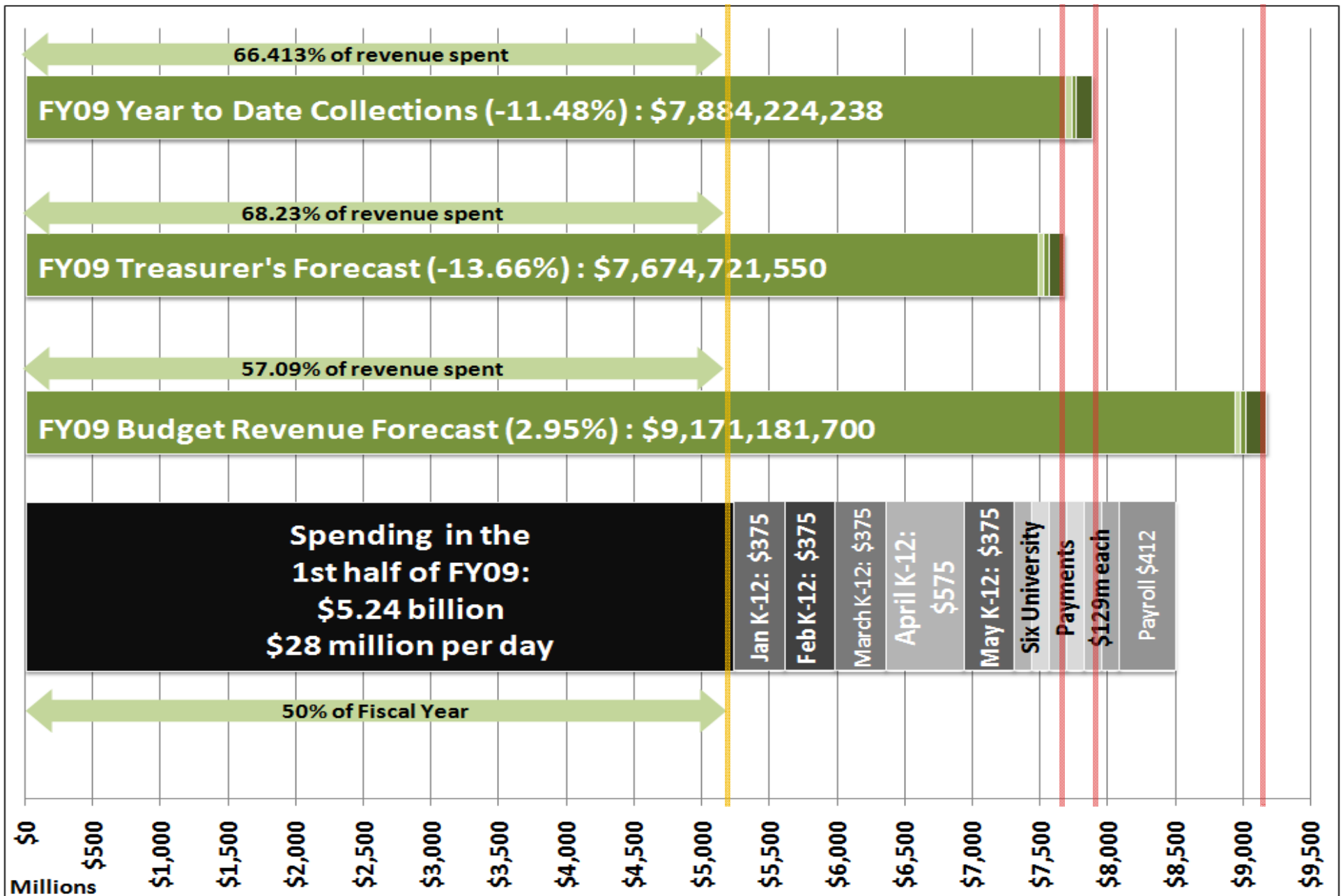


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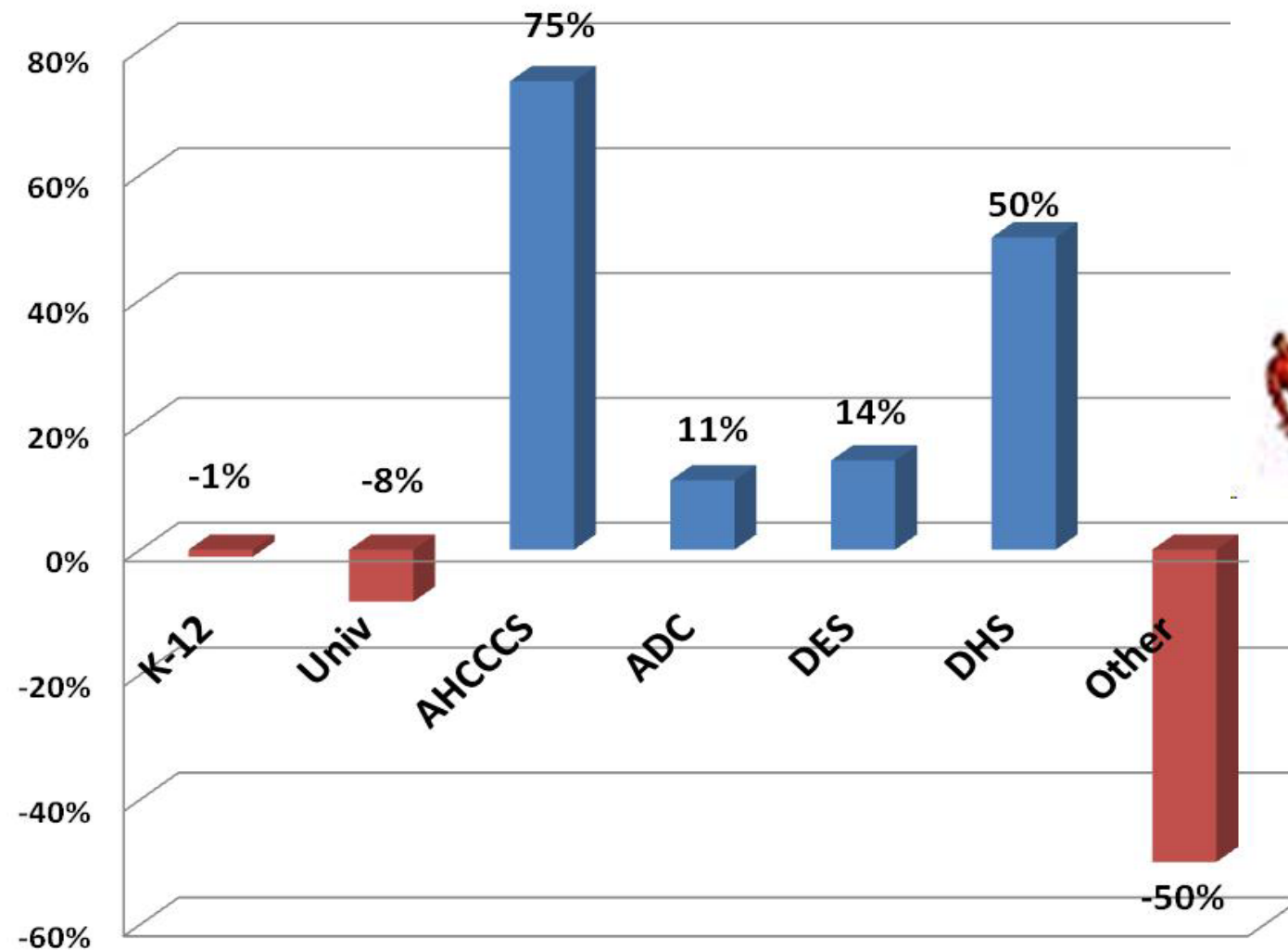
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# Where is the money going?

## % Change in “slice of the GF pie”



**Fiscal  
Years  
1999-  
2009**



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