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Joint Legislative Budget Committee

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FINANCE ADVISORY COMMITTEE

December 12, 2006

Senate Hearing Room 1 – 9:30 a.m.

Members Present:

Dan Anderson, Arizona Board of Regents
Tracy Clark, Arizona State University
John Lucking, ECON-LINC
Georganna Meyer, DOR
Elliott Pollack, Elliott D. Pollack and Co.
Martin Schultz, Arizona Public Service
Marshall Vest, University of Arizona
Don Wehbey, Department of Economic Security

Mr. Richard Stavneak, Director, JLBC Staff, opened the meeting at 9:45 a.m. and welcomed everyone to the Finance Advisory Committee (FAC) meeting.

Mr. Stavneak started the JLBC Staff presentation with an overview of state revenues and issues for the panel to consider. ([Click here to view.](#))

Mr. Hans Olofsson, JLBC Staff, continued the presentation on Individual Income Tax.

Mr. Stavneak said the positive forecast for capital gains, especially from the stock market, may replace capital gains from real estate in the previous year. This volatility creates challenges in forecasting the individual income taxes.

Mr. Brian Cary, JLBC Staff, continued the presentation on Sales Tax Collections.

Mr. Elliott Pollack asked what the percentage of total sales tax is for contracting. Mr. Cary replied that contracting is more than 22% of the total this year versus 21% a year ago.

Mr. Pollack asked if the tax from a house is collected when the material is purchased or when the house closes. Ms. Georganna Meyer replied that she believes the tax is charged when the house closes.

Mr. Pollack stated that in looking at house closings, they have not come down at all. However, permits are at 50% less than a year ago. Contracting taxes are higher because the house closings have not yet decreased and prices are high because the houses that are closing were contracted and built 9 months to 1 year ago. Contracting revenues will fall, perhaps even go negative, in 6 months. If taxes are collected when houses are closed, there will be a problem.

Mr. Stavneak continued the presentation with a summary of the Big 3 Forecast Growth.

Mr. Pollack gave a slide presentation and handout on the national economy. ([Click here to view.](#))

Mr. Stavneak asked Mr. Pollack's perspective relative to the state.

Mr. Pollack said that the contracting analysis shows that revenues will fall within the next 4 to 6 months.

Mr. Tracy Clark gave a presentation on the Arizona outlook. ([Click here to view.](#)) He said that there is weakness in retail sales and potential weakness in corporate and personal income tax. The overall economy does not look bad; the impact on the revenues will be disproportionate. Auto sales will be weaker. Retail sales have more downside potential because of the inability of people to refinance their credit card debt.

Mr. Marshall Vest asked if the year-to-date categories (*illustrated on page 15 of the JLBC presentation*) are Arizona based data. Mr. Cary replied that it is Arizona based data.

Mr. Vest asked if the categories can be broken down to a mixed code basis.

Ms. Meyer replied that they are working on mixed data.

Mr. Vest asked what category manufacturing would be in the data.

Mr. Cary replied that in the mix code, the seller is included in the manufacturer and the product is subject to sales tax.

Mr. Tim Everill asked the panel for their perspective on the economy.

Mr. John Lucking said that Mr. Pollack pointed out the change in unit labor cost. The concern is the dollar declines substantially. Banking and international settlements, the reserves held for Russia and OPEC countries, that on the dollar are at 64% is an indication of things to come. Foreign inflation can pick it up because foreign business is more expensive and the U.S. exporters are more competitive, so they have a larger market. The dollar decline presents an increase to inflation. Also, with capital gains, there may be some people that take capital gains now rather than wait to see what Congress says next year or the year after. It might be a surprise ending with strong capital gains inflow. The key points are inflation and capital gains.

Mr. Dan Anderson agrees with the panel. One overall concern is the housing industry and the potential oversupply. With so many people that have gotten into the market place having been less than prime borrowers, how many of them will be able to sustain the payments in the months ahead. There may be more supply because of not only the existing supply, but also some of the houses currently occupied that can come into the marketplace. The state is better poised than most states for growth. It is going to be a slower economy, however, if there is a recession, it will be fairly mild and short-lived.

Mr. Martin Schultz said that from the company standpoint, although there is a slowdown in housing, there is still a continuing increase in hookups in subdivisions. There is great strength in the commercial market that is not slowing down, investments are being made and construction is continuing.

Mr. Marshall Vest said that as real estate and construction levels off, which is an industry that is at least a fourth of the growth in recent years, there is a significant risk of decline which will have an effect on the economy. The surprise is that measures of employment and personal income are good. The only slowdown is in the sales category. There has been little slowdown of real estate on the economy, but it will become visible in the future. This is not a recession, just slower growth.

Mr. Don Wehbey said that it is clear that the economy is slowing. He expected to see faster growth in the first and second half, but is seeing slowing in the second half. The second quarter QCEW report seems to appear similar to the first quarter. The economy, according to that data, still looks good. There is four quarter average wage growth above 12%. There is still high firm growth of 9%. There is employment growth of 5.9%. DES estimates show a slowdown, a new report shows unemployment growth of 4.7%. The Arizona economy has momentum going forward, even in the second quarter. It is another strong year. The issue still posing a risk is energy.

The meeting adjourned at 10:47 a.m.

Yvette Medina, Secretary

Tim Everill, Revenue Section Chief

NOTE: A full tape recording of this meeting is on file in the JLBC Staff office at 1716 West Adams.

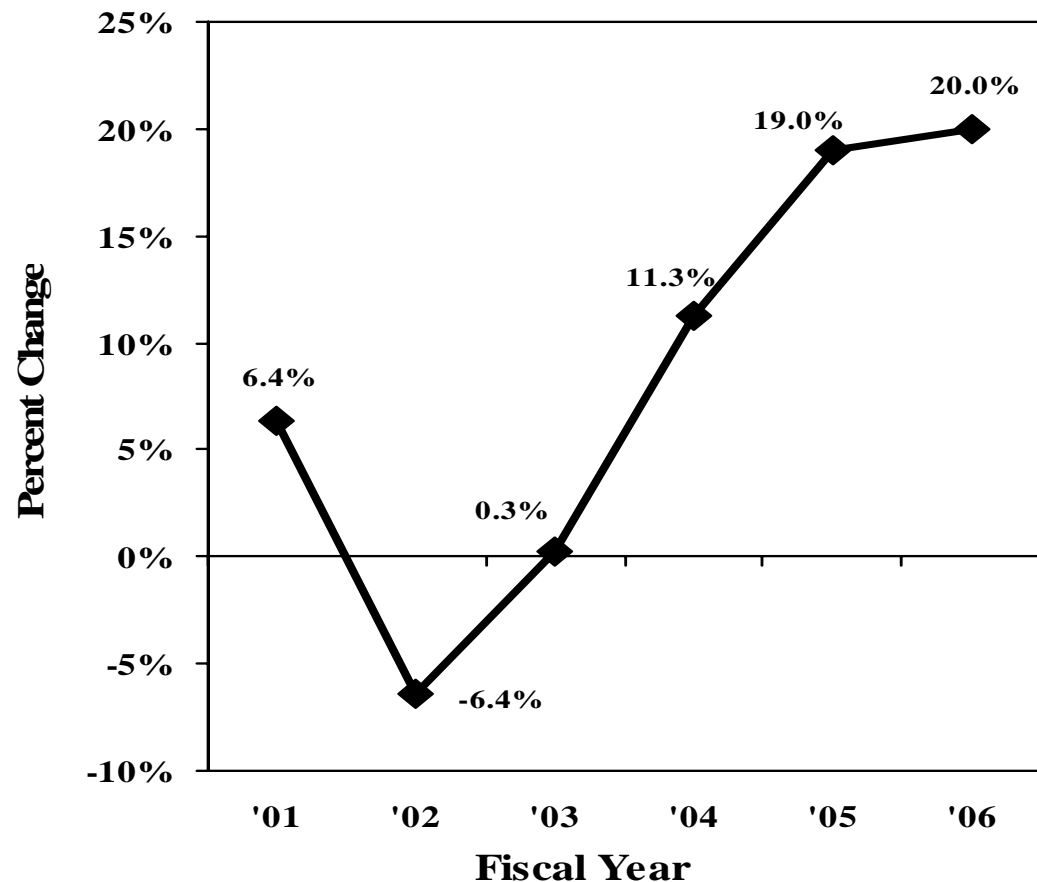
Finance Advisory Committee

December 12, 2006

JLBC

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.**



Growth in 1st Five Months of FY 2007 Is Down From Last Year, But Still Double-Digit

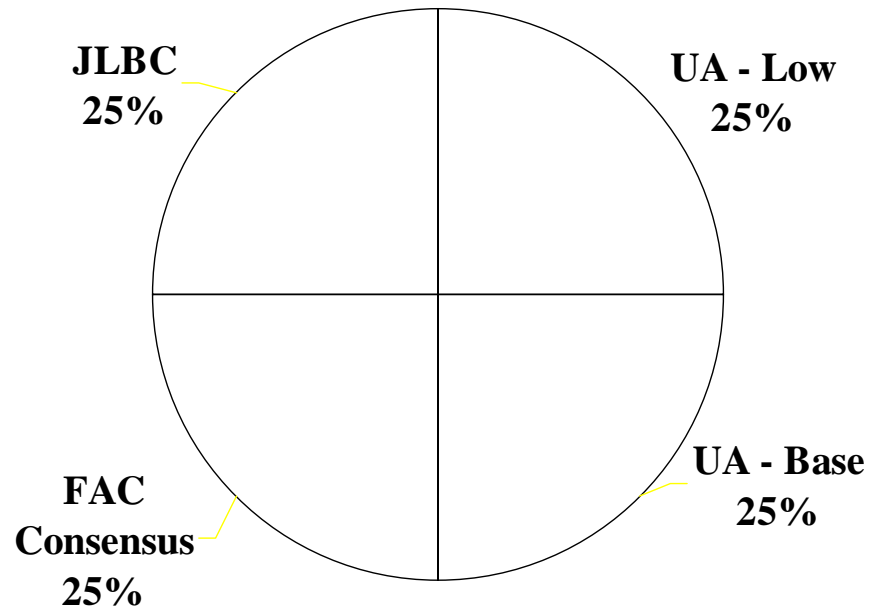
- July-November revenues are 10% above last year.
- Sales tax is up over 9%.
- Individual income tax is up over 9%, although it is unclear how much of this increase was aided by '06 “hang-over” – some payments reflect '05 liabilities.
- Corporate income tax is up almost 22%.

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

UA Model Represents 50% of the Forecast

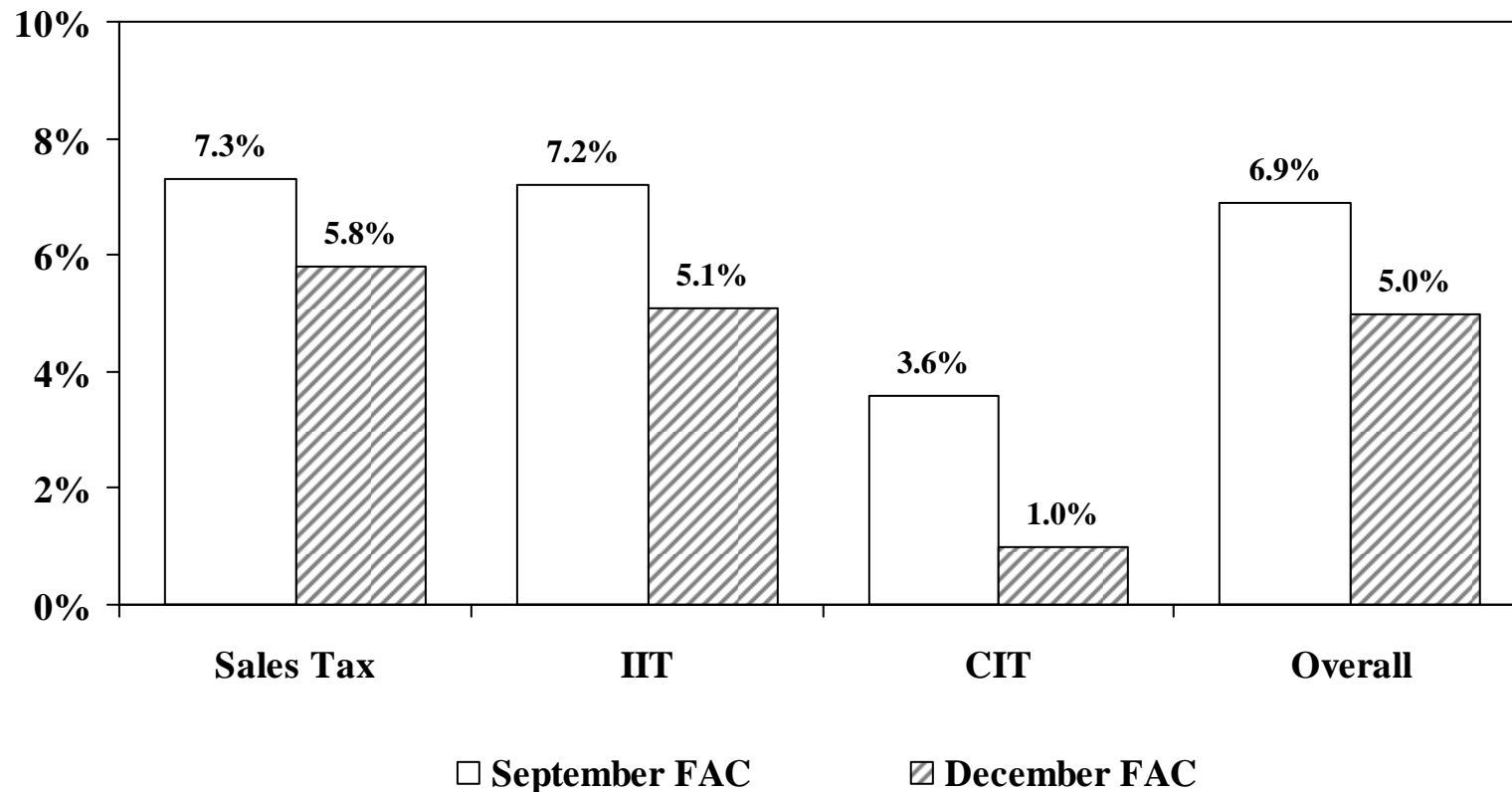
**Big 3 forecast equally
weights:**

- **FAC average**
- **UofA model - base**
- **UofA model - low**
- **JLBC staff forecast**
- **Remaining revenues (6% of total) are staff forecast**

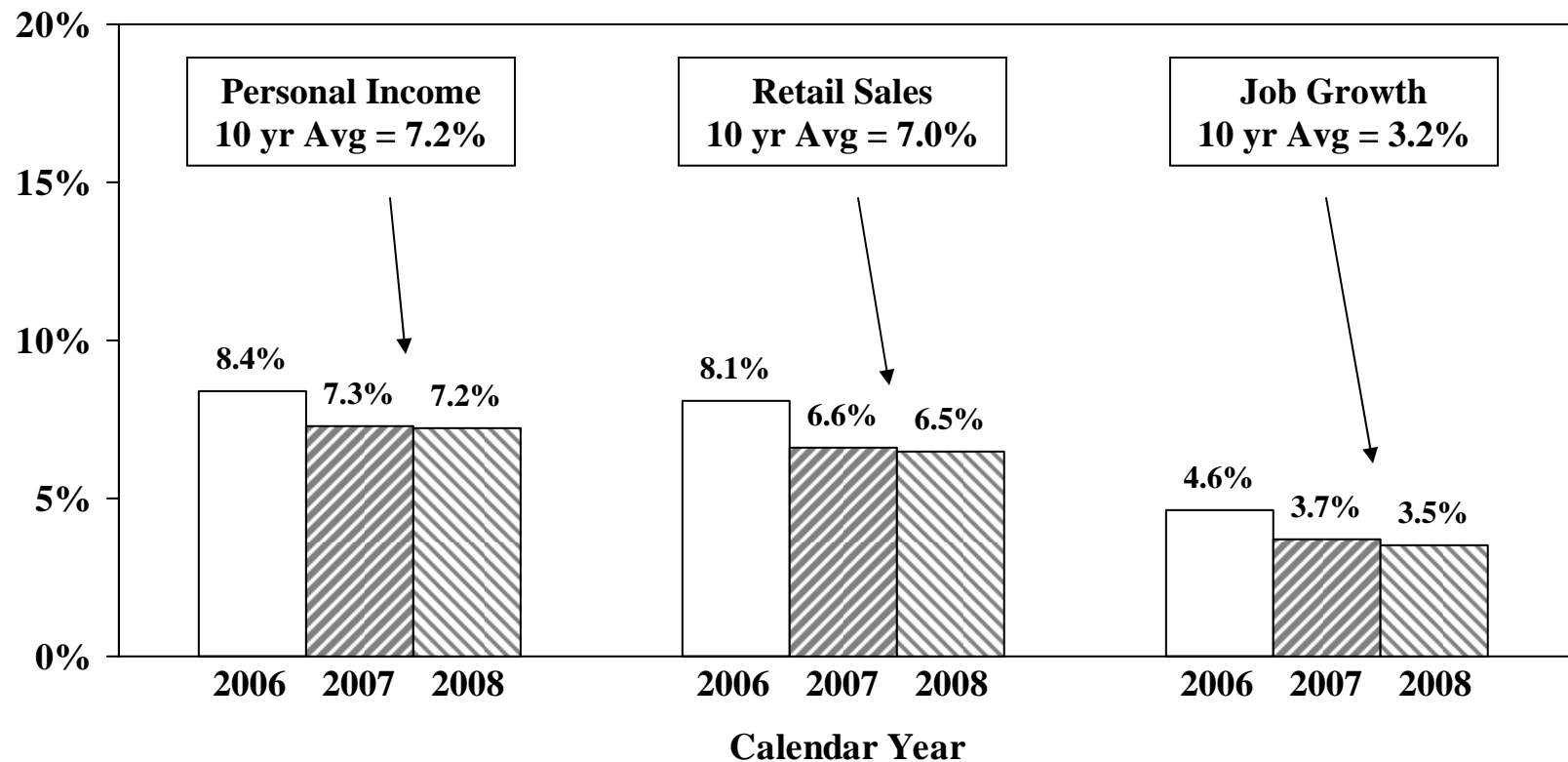


FAC Forecast More Cautious Since September

- Overall FY 2008 Growth Projection Declined From 6.9% to 5.0%.
- Long Term Average Growth is 7%

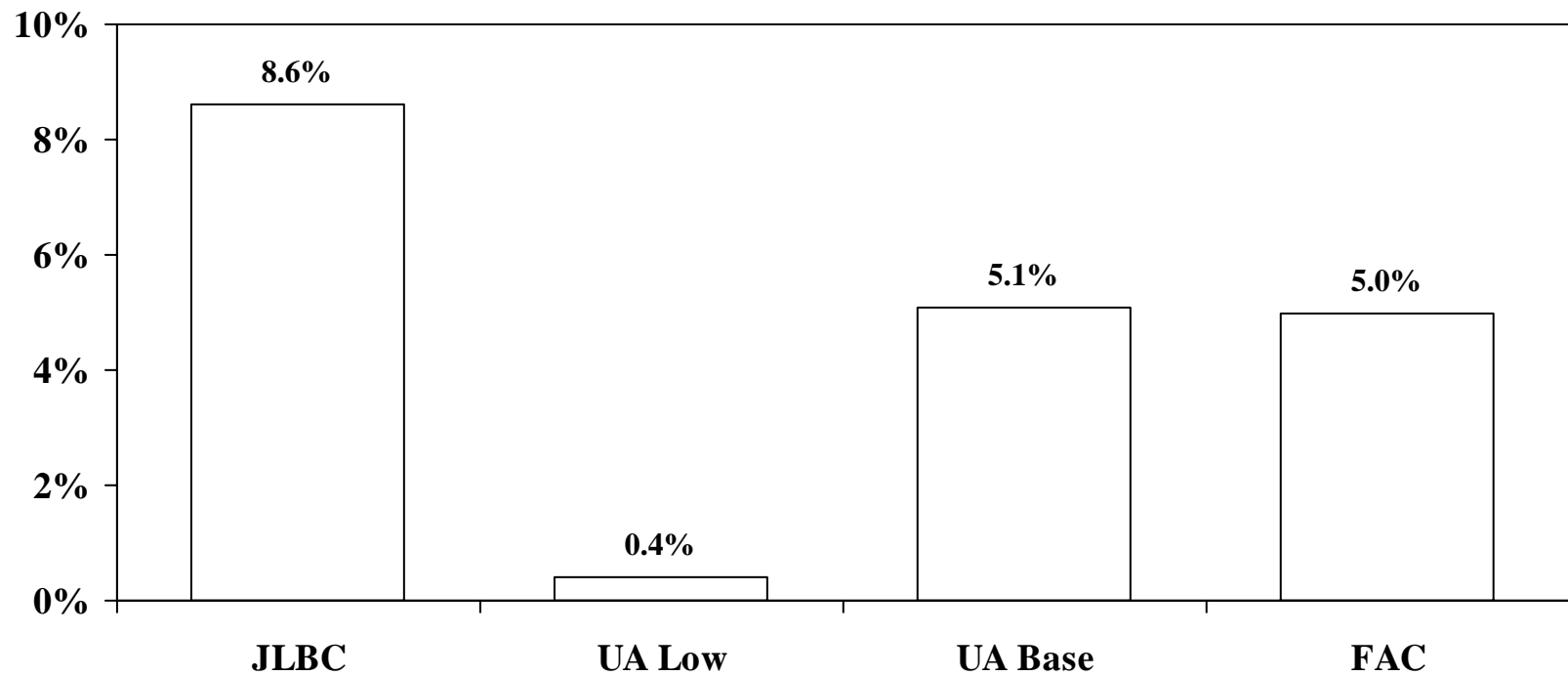


While FAC Has Become More Cautious, Blue Chip Continues to Forecast Growth Near Historical Averages



Source: November 2006 Arizona Blue Chip

While FAC Forecasts Below Average Growth, the UA Low Model Represents A Recession Scenario - “Big 3” FY 2008 Forecast Weighted Averages by Input

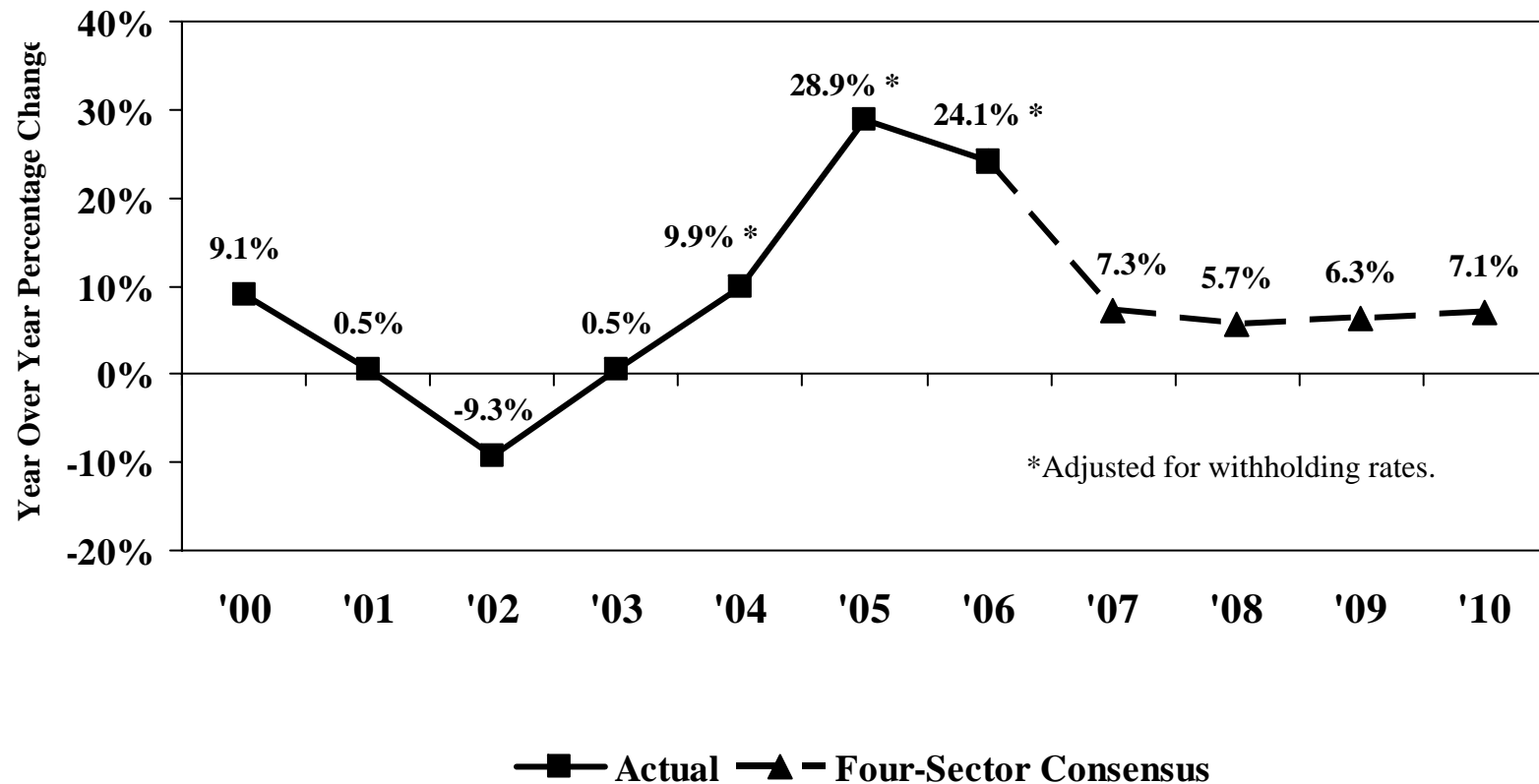


Evaluating the Odds of Flat Revenue Growth - How Does that Compare to the Odds of a Recession?

- 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 15%
 - 10 most pessimistic place odds at average of 36%
- 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

Individual Income Tax

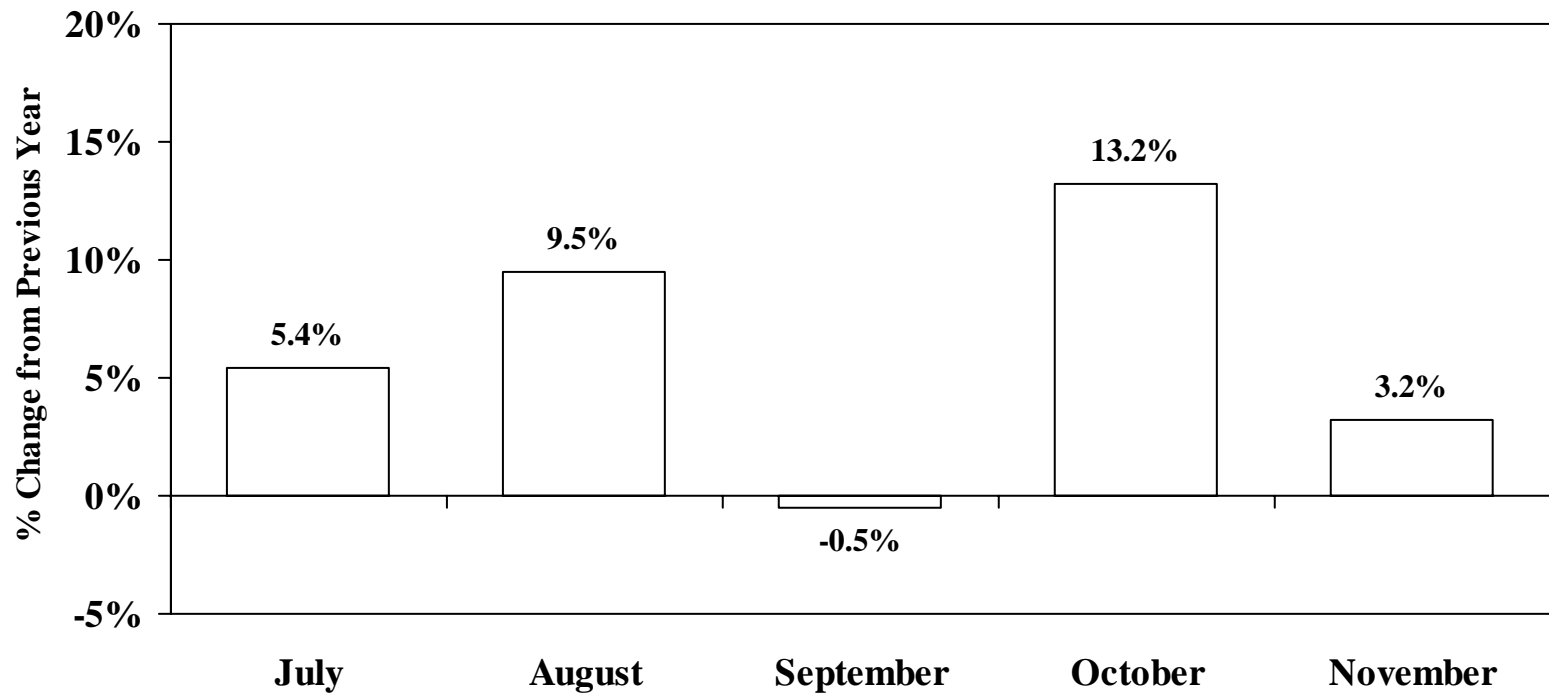
4-Sector Consensus Forecast Calls For 5.7% Growth in FY 2008



After 2 Years of Double Digit Withholding Growth, FY 2007 Collections Have Been Much More Uncertain

- Withholding YTD Growth is 6.3% Over FY 2006

- 46% Growth in Estimated/Final Payments Pulls Overall Average to 9.4%

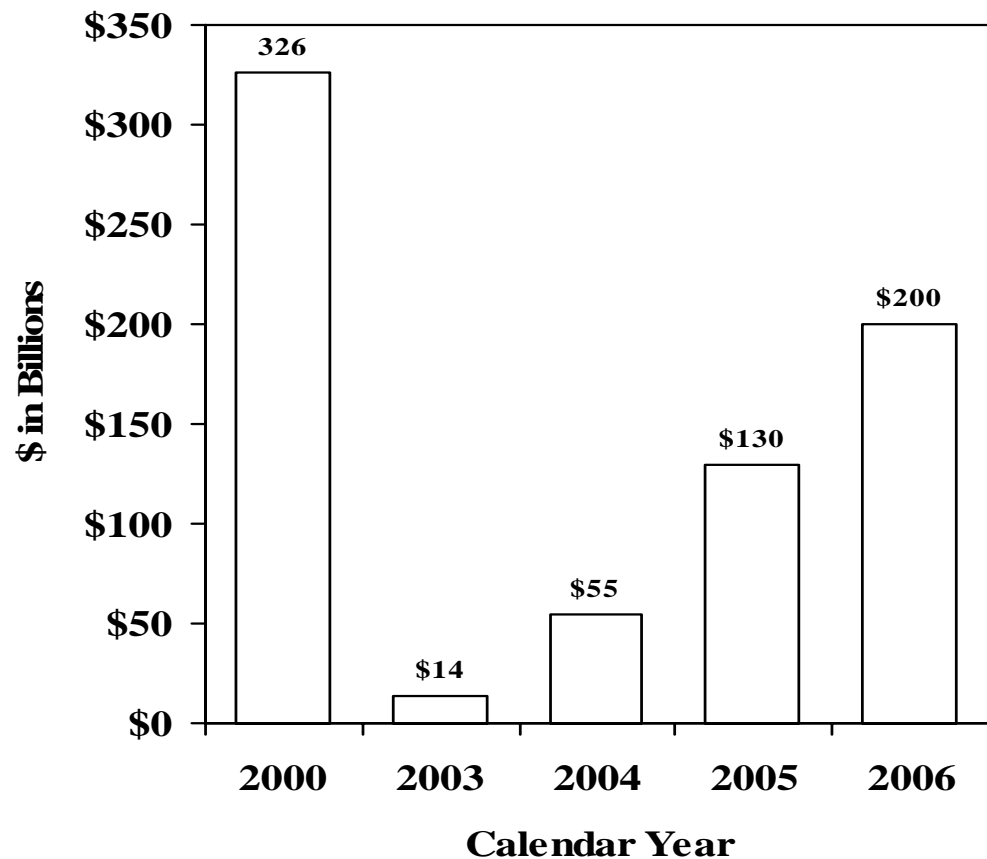


Growth over same month in Prior Year

National Capital Gains Distributions Are Expected to Increase Dramatically

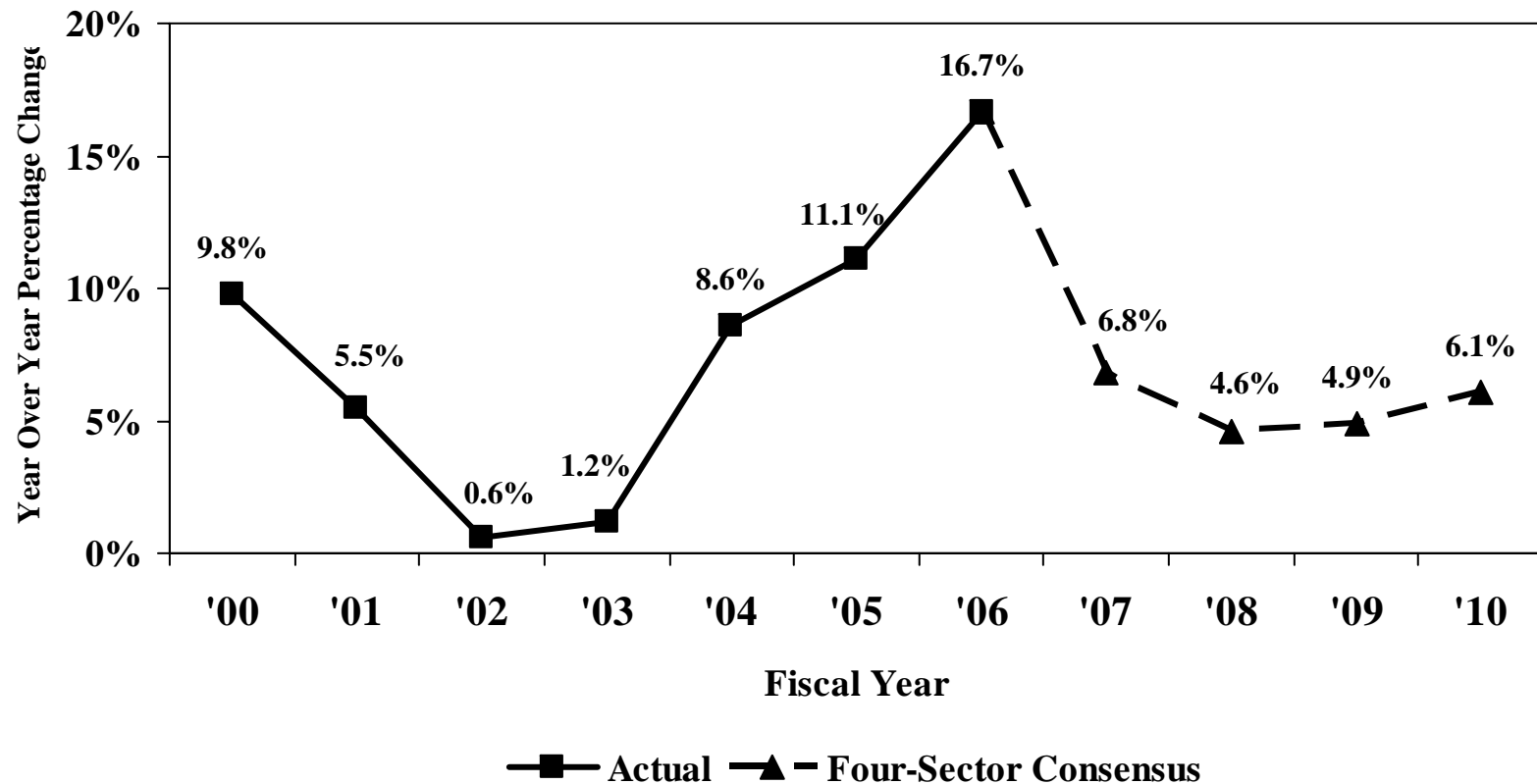
- Distribution Changes Help Explain Volatility in Income Tax Collections

- Losses from the last “bear market” have been used up.
- Distributions in CY ‘06 are expected to increase by 50%.
- Arizona’s share may contribute \$80-\$90 million to FY07 IIT collections.
- These gains may be offset by less real estate activity.



Sales Tax Growth Rate

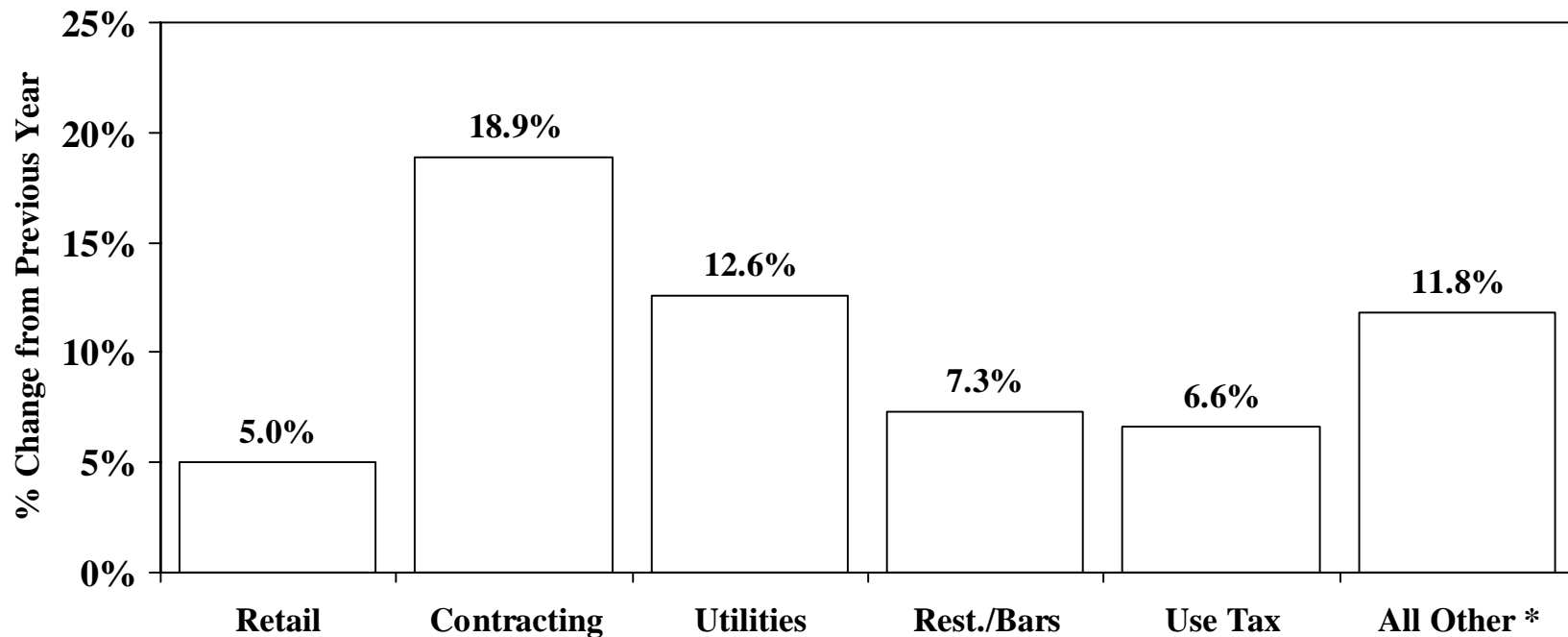
4-Sector Consensus Forecast Calls For 4.6% Growth in FY 2008



FY 2007 Sales Tax Collections Have Slowed in Some Major Categories

- Overall Growth is 9.5%

- Contracting Activity Remains High While Retail Lags



FY 2007 Year to Date – (Through October)

* Represents 10% of total collections.

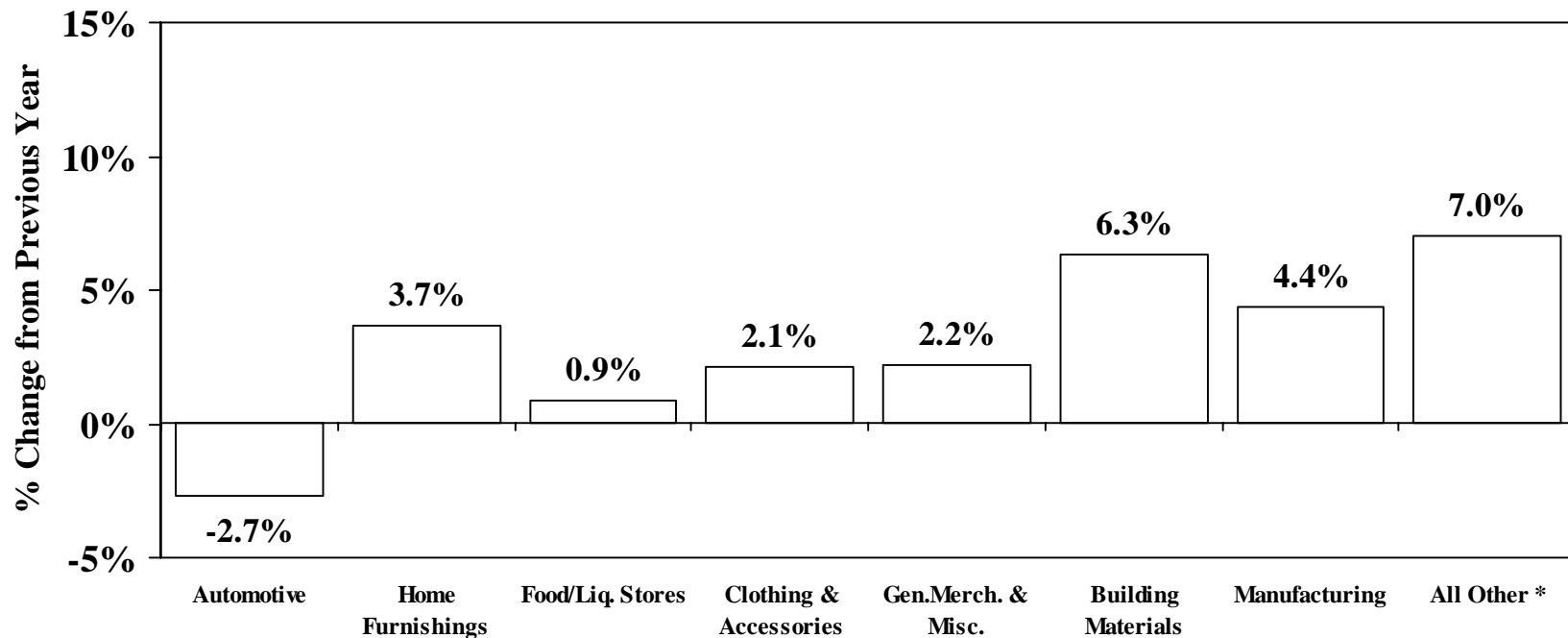
If Homebuilding Is Down, Why Has Contracting Growth Remained High?

- Nonresidential construction activity remains at high levels.
- With housing costs still high, some homeowners may be using their equity to improve their existing residences rather than move to a different home.

Some Retail Sales Categories Have Struggled in Recent Months

- Overall Growth is 5.0%

- Construction Related Retail Has Been Stronger Than Other Categories



FY 2007 Year to Date – (Through October)

The Housing Slump and Fuel Prices May Be Affecting Sales Tax Collections

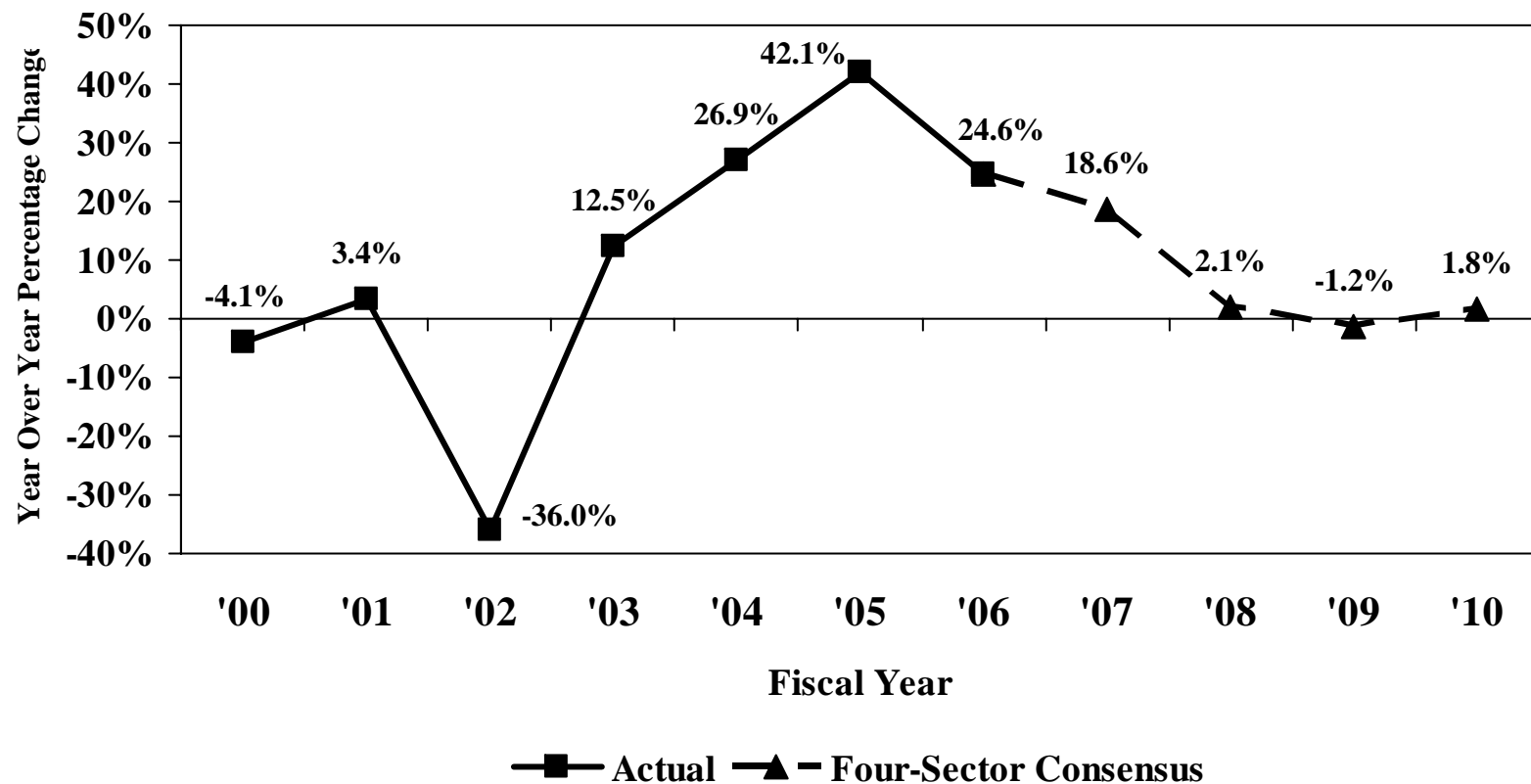
- Home price appreciation and low interest rates helped fuel consumer spending in FY 2005 and FY 2006.
- Higher interest rates have curbed demand for new homes and big-ticket items.
- High gasoline prices soaked up discretionary income and may have curbed spending on non-durable items.

Holiday Season Sales May Fall Short of Last Year's Results

- The National Retail Federation projects holiday sales will increase 5% this year, down from 6.1% in 2005.
- Forrester Research forecasts U.S. online retail sales, much of which escapes taxation, will increase 23% in the 2006 holiday season from a year ago .

Corporate Income Tax Growth Rate

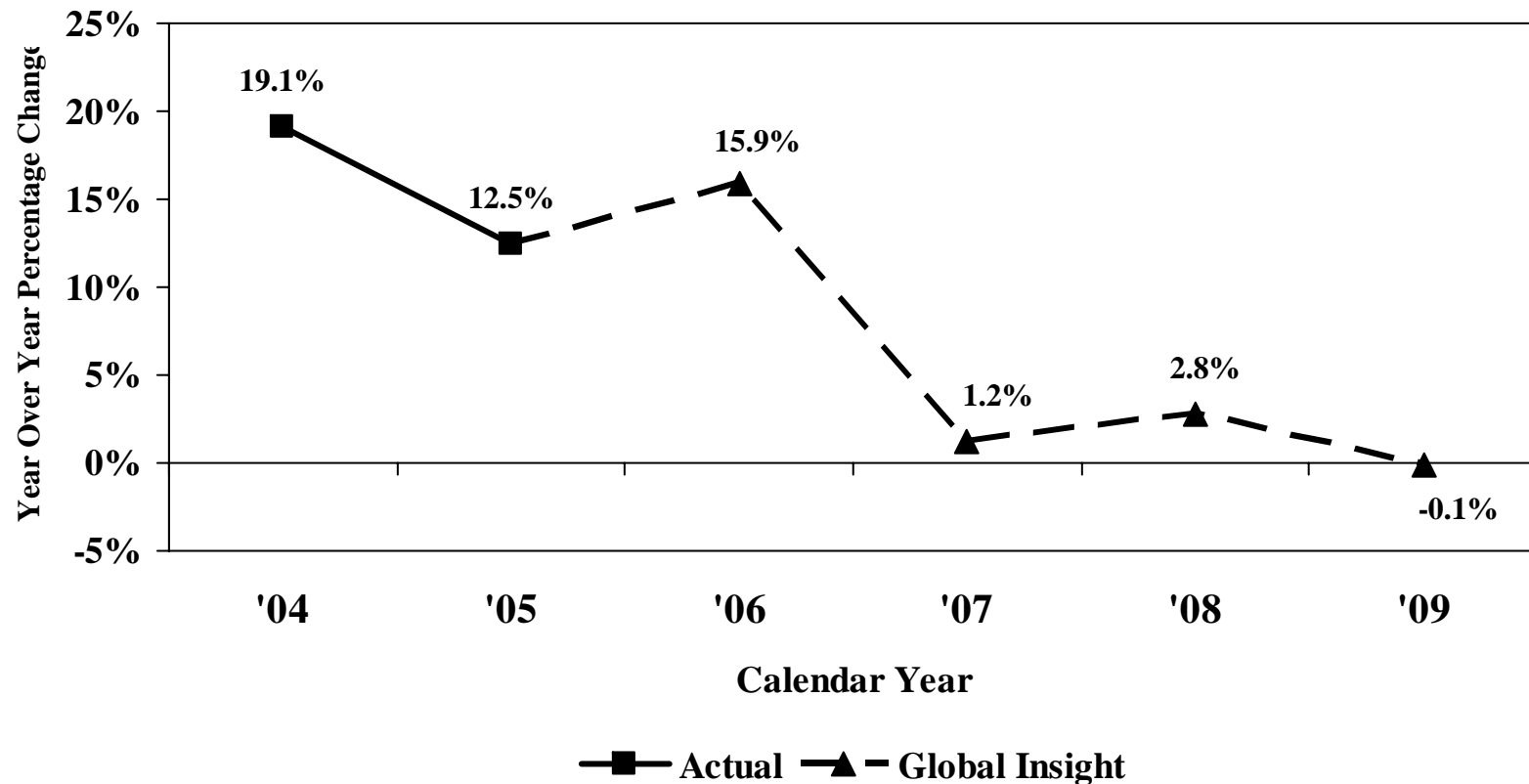
4-Sector Consensus Forecast Calls For 2.1% Growth in FY 2008



FY 2006 Actual = \$874 Million

U.S. Corporate Profits are Expected to Slow

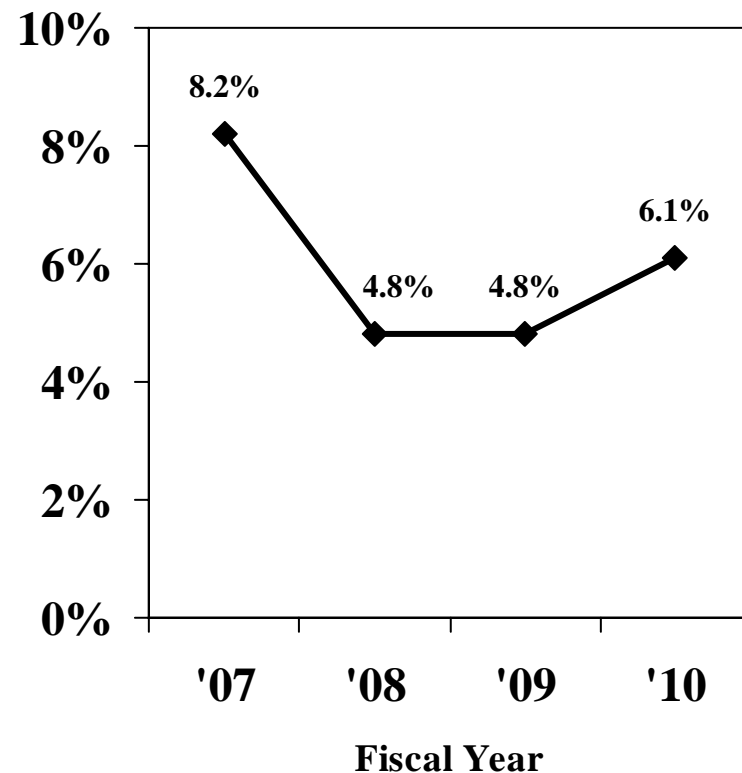
- Global Insight Forecast Comparable to Blue Chip
- These National Forecasts Support 4-Sector Revenue Projection



Big 3 Forecast Growth

Four-Sector Consensus Forecast Has Growth of 8.2% in FY 2007 and 4.8% in FY 2008

- '07 Growth of 8.2% would be steep decline from 20% in '06, but close to budgeted rate.
- '08 Forecast is pulled down by flat growth scenario in the UA-Low Model.
- Without UA-Low, '08 grows by 6.2%.



FY 2007-FY 2010 Quartile Forecast Worksheet

	FY 2007	FY 2008	FY 2009	FY 2010
<u>Sales Tax</u>				
JLBC Forecast (12/06)	8.8%	8.5%	8.2%	7.0%
UA - Low (11/06 revision)	4.9%	0.3%	1.4%	4.5%
UA - Base (11/06 revision)	5.6%	3.8%	4.8%	6.5%
FAC (12/12/06 Survey)	7.9%	5.8%	5.3%	6.2%
Average:	6.8%	4.6%	4.9%	6.1%
<u>Individual Income Tax</u>				
JLBC Forecast (12/06)	9.1%	8.9%	8.3%	7.0%
UA - Low (11/06 revision) withholding	4.2%	2.7%	4.4%	6.9%
UA - Base (11/06 revision) withholding	8.1%	6.2%	6.6%	7.7%
FAC (12/12/06 Survey)	7.9%	5.1%	5.8%	6.8%
Average:	7.3%	5.7%	6.3%	7.1%
<u>Corporate Income Tax</u>				
JLBC Forecast (12/06)	15.0%	8.0%	5.0%	2.5%
UA - Low (11/06 revision)	23.4%	-7.0%	-13.3%	-4.6%
UA - Base (11/06 revision)	27.9%	6.2%	0.0%	1.7%
FAC (12/12/06 Survey)	8.1%	1.0%	3.7%	7.7%
Average:	18.6%	2.1%	-1.2%	1.8%

Consensus Weighted Average:	8.2%	4.8%	4.8%	6.1%
JLBC Weighted Average:	9.5%	8.6%	7.9%	6.5%
UA Low Weighted Average:	6.4%	0.4%	1.1%	4.7%
UA Base Weighted Average:	8.8%	5.1%	5.0%	6.5%
FAC Consensus Weighted Average:	7.9%	5.0%	5.4%	6.6%

National Economy

Prepared for:
Finance Advisory Committee

Elliott D. Pollack & Company

December 12th, 2006

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:

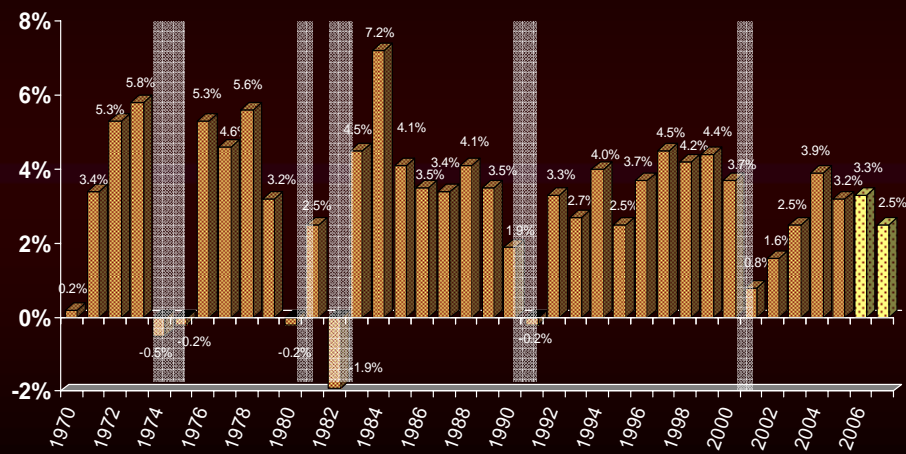
Collapse of housing prices

What is the national Blue Chip panel telling us?



United States Real Gross Domestic Product* Annual Growth 1970 - 2007**

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



* Based on chained 2000 dollars.

** 2006 - 2007 are forecasts from the Blue Chip Economic Indicators, November 2006

Recession Periods

ODDS OF A RECESSION

Source: National Blue Chip Panel

November consensus: 24.8%

October consensus: N/A

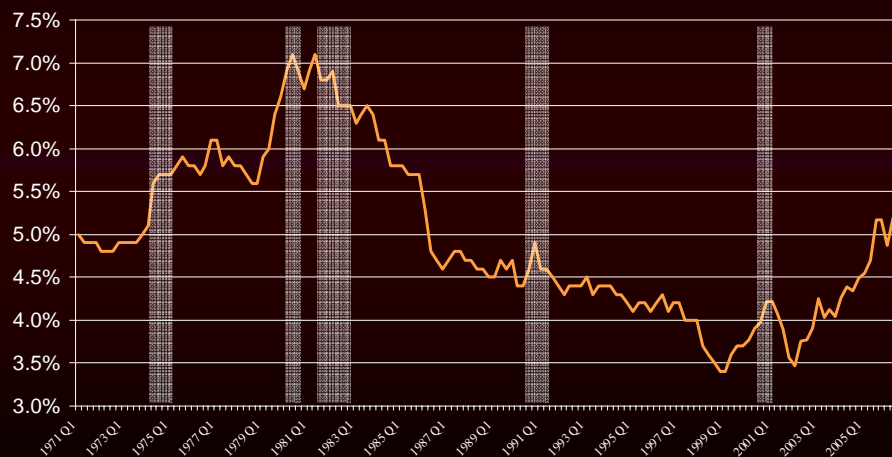
September consensus: 25.1%

August consensus: 26.9%

Consumer Energy Goods & Services Spending as a Percent of Personal Income

1971 – 2006*

Source: Bureau of Economic Analysis



*Data through third quarter 2006

Recession Periods

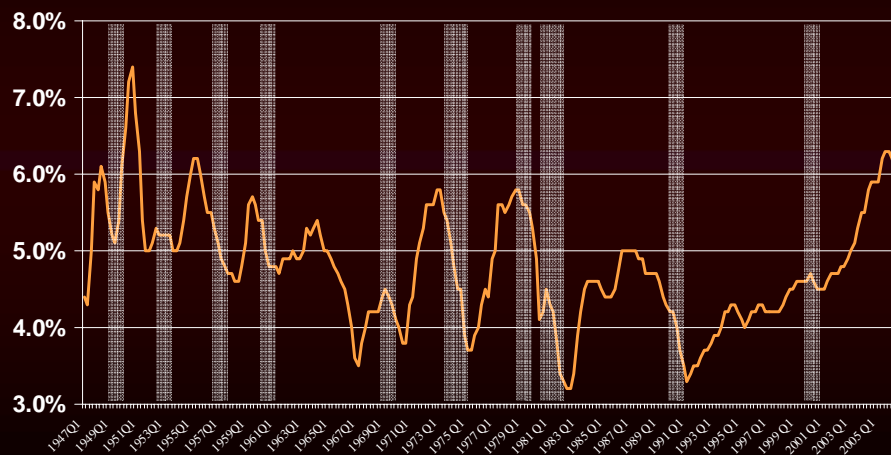
The future of oil prices is uncertain...

The longer they are high, the greater probability of viable alternatives being found.

Residential Investment as a Percent of GDP

1947 – 2006*

Source: Bureau of Economic Analysis



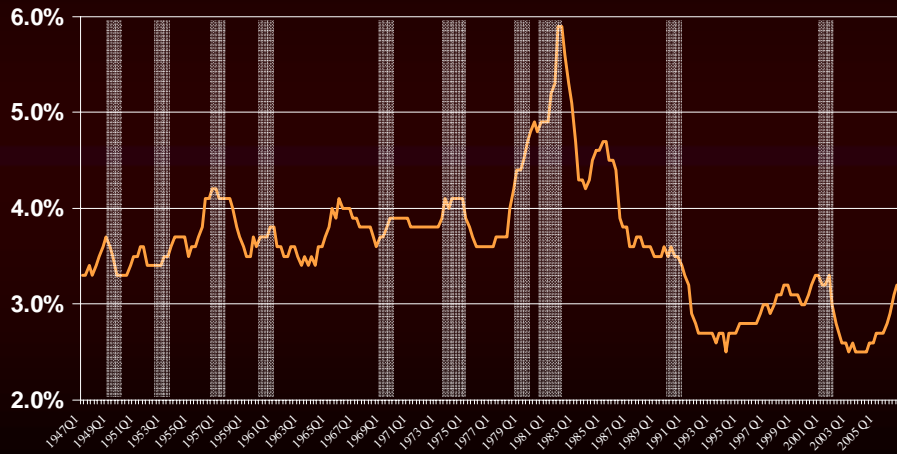
*Data through third quarter 2006

Recession Periods

Non-Residential Structures Investment as a Percent of GDP

1947 – 2006*

Source: Bureau of Economic Analysis



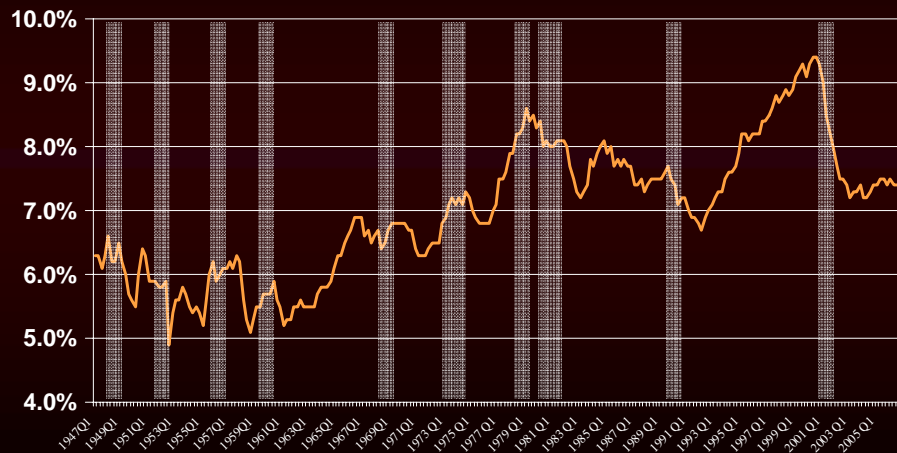
*Data through third quarter 2006

Recession Periods

Equipment & Software Investment as a Percent of GDP

1947 – 2006*

Source: Bureau of Economic Analysis

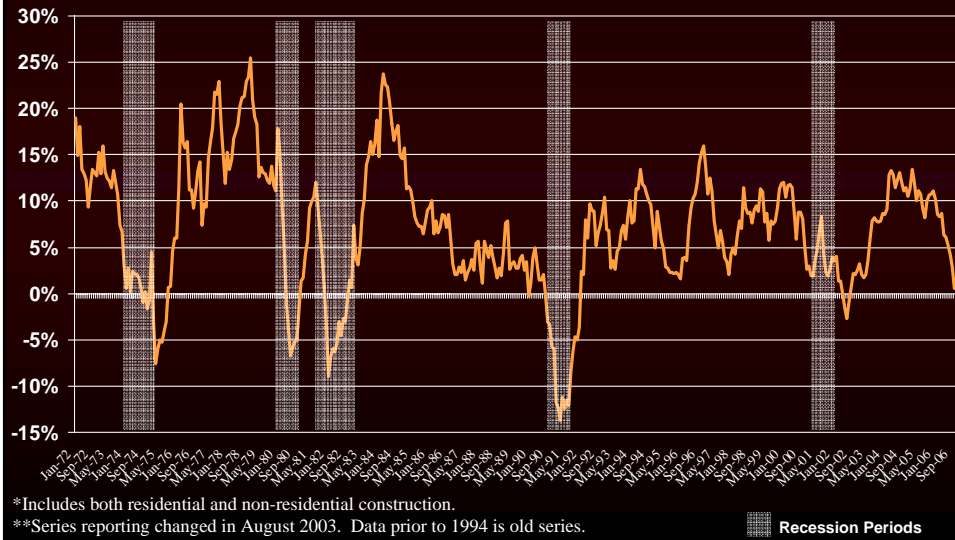


*Data through third quarter 2006

Recession Periods

Value of Total Construction Put-In-Place* Percent change Year Ago January 1972 – October 2006

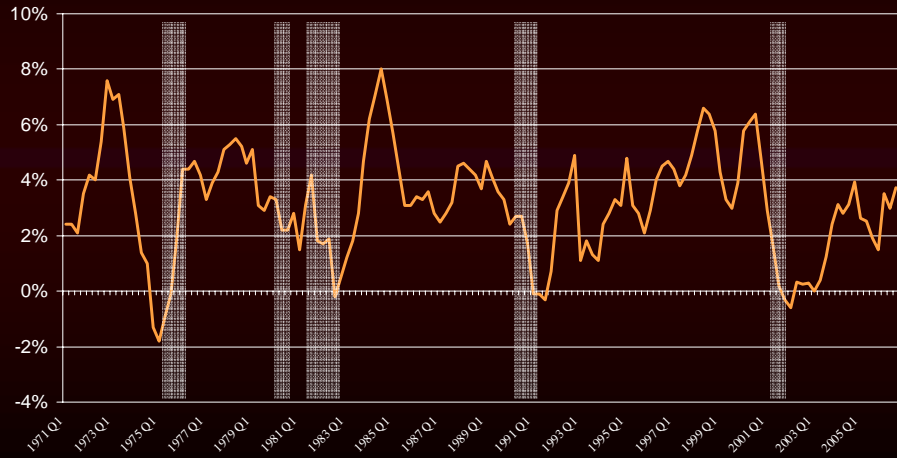
Source: U.S. Census Bureau



Are people making ends meet?

U.S. Real Personal Income Percent Change Year Ago 1971 – 2006*

Source: Bureau of Economic Analysis

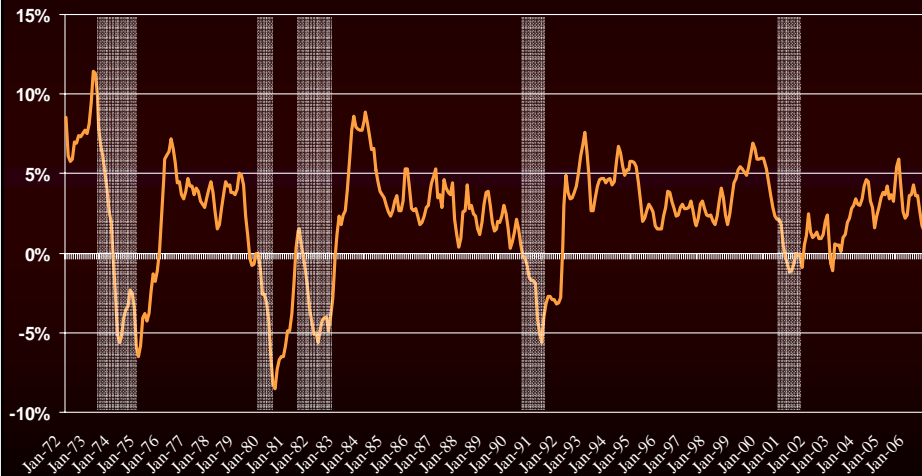


*Data through third quarter 2006

Recession Periods

U.S. Real Retail Sales Percent Change Year Ago, 3-Month Moving Average 1972 – 2006*

Source: Federal Reserve Board of St. Louis



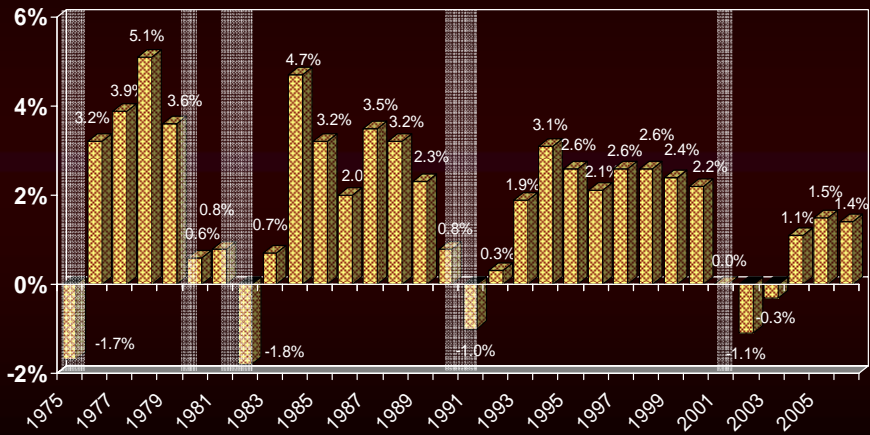
* Data through October 2006

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.

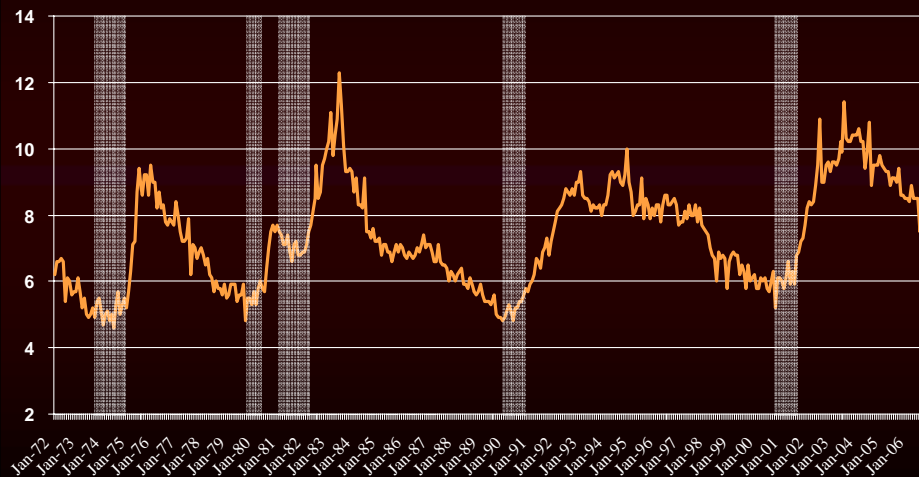
*Data through October 2006

Recession Periods

Median Weeks Unemployed (S/A)

1972 – 2006*

Source: Bureau of Labor Statistics

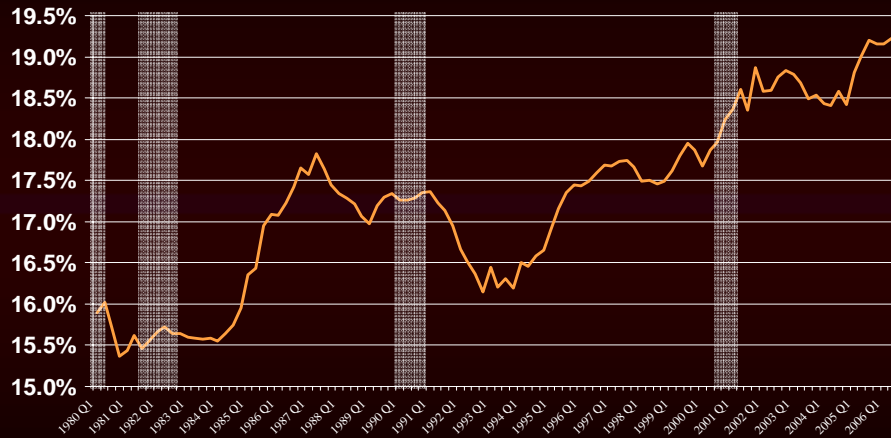


*Data through October 2006.

Recession Periods

Financial Obligation Ratio 1980 – 2006*

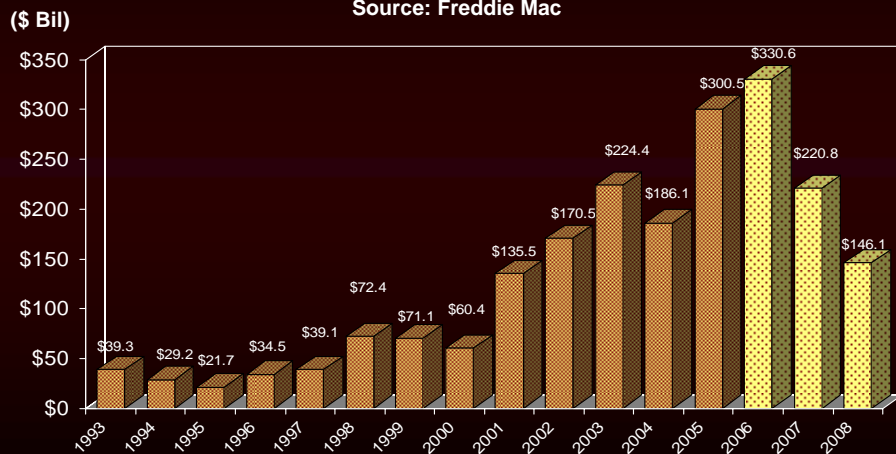
Source: Board of Governors, Federal Reserve Board



NOTE: The FOR includes debt service payments as a percent of disposable income. The FOR is a broader measure as it includes auto lease payments, rental payments, homeowner's insurance and property taxes.
*Data through second quarter 2006.

Home Equity Cashed Out During Mortgage Refinancings, Second Mortgages and Home Equity Credit 1993–2008*

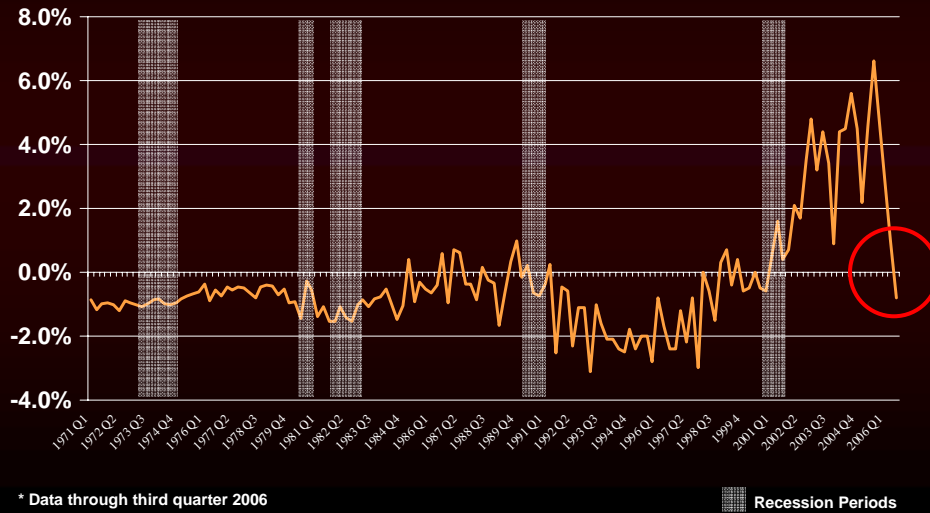
Source: Freddie Mac



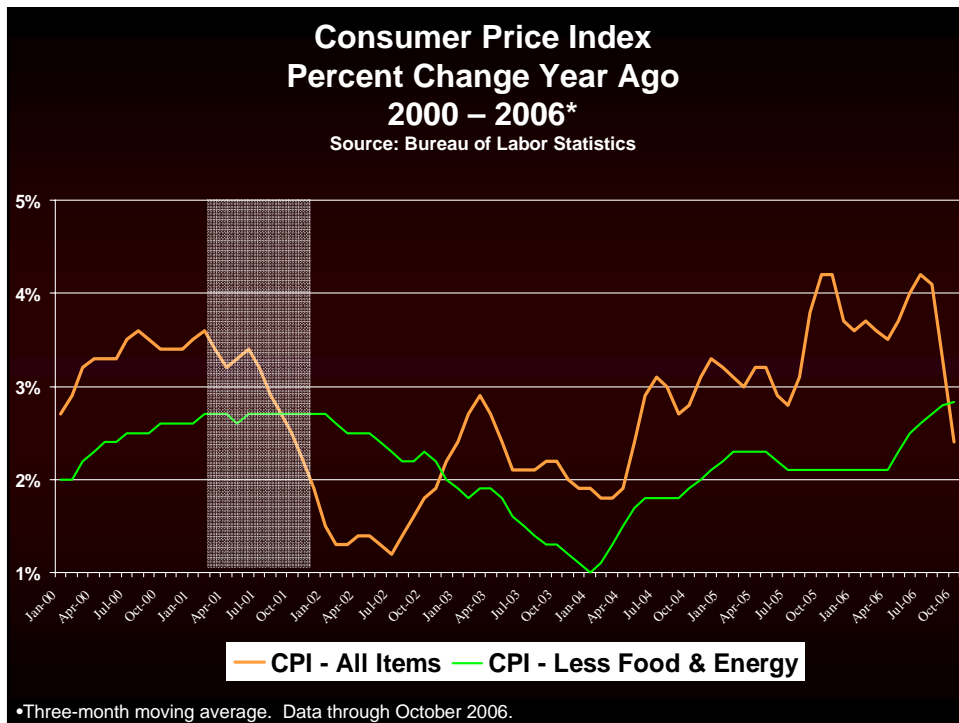
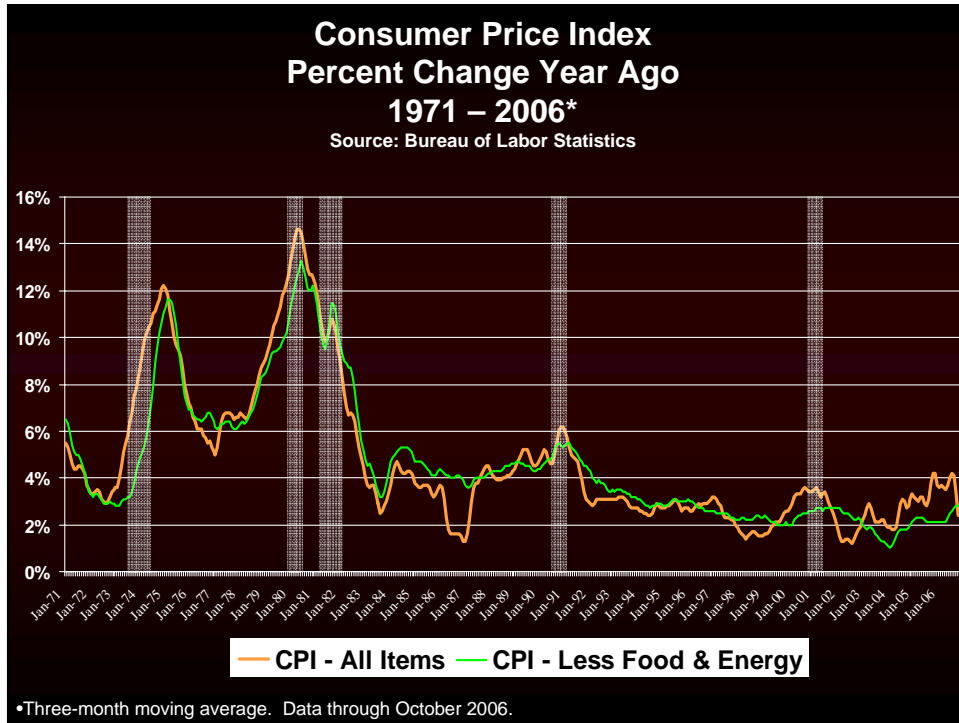
* 2006 -2008 forecasts are from Freddie Mac

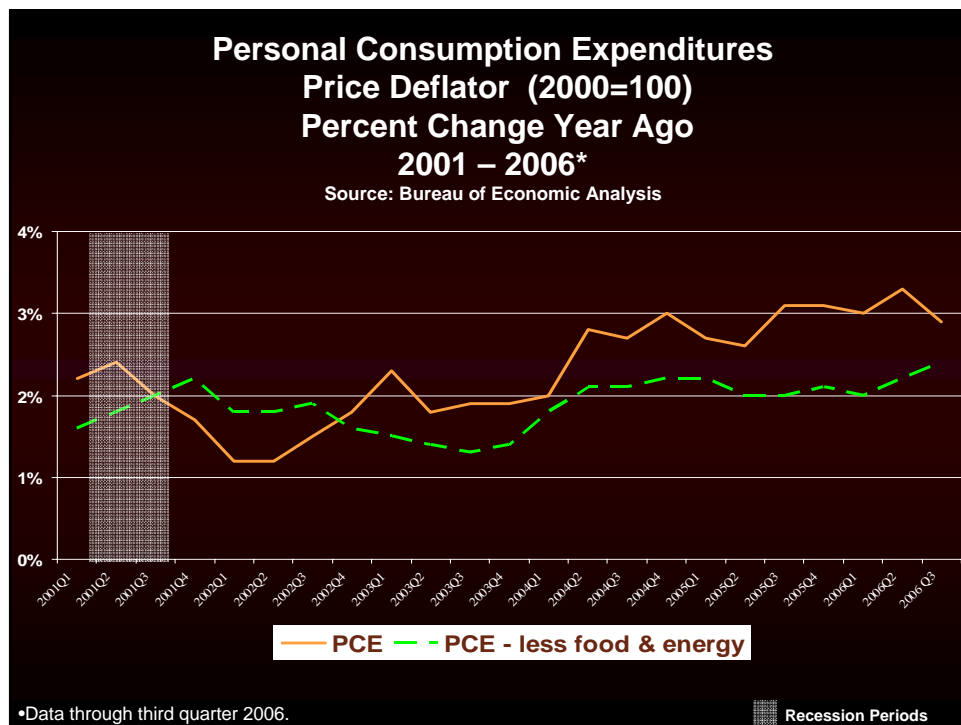
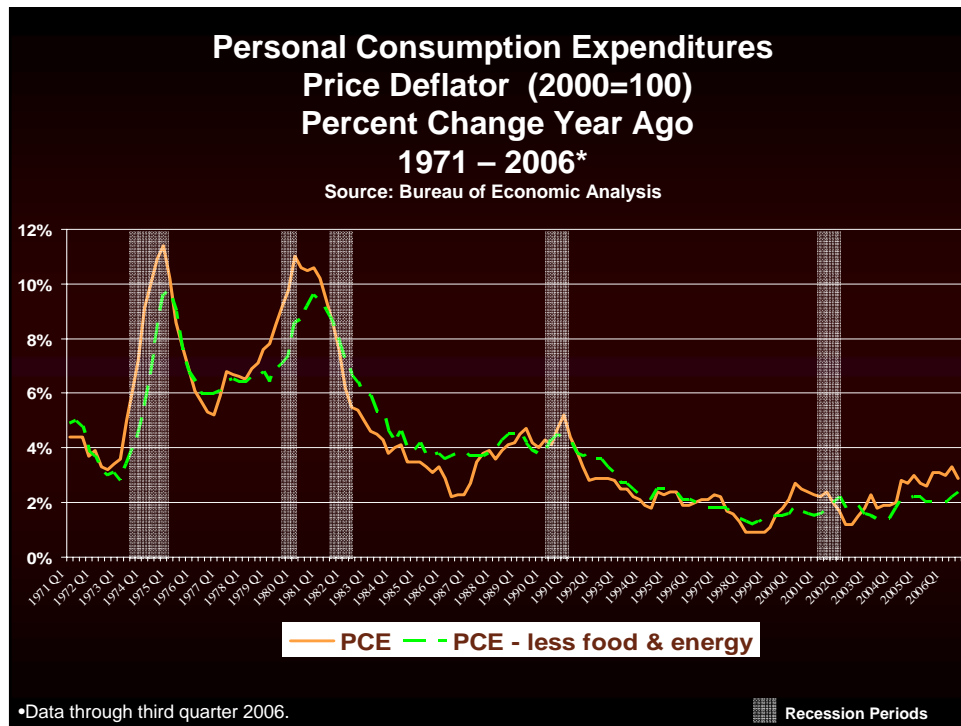
Mortgage Equity Withdrawal as a share of Disposable Income U.S.: 1971 – 2006*

Source: Bureau of Economic Analysis



Will inflation get ugly?





30-Year Conventional Mortgage Rates

1982 – 2006*

Source: Federal Reserve Economic Database

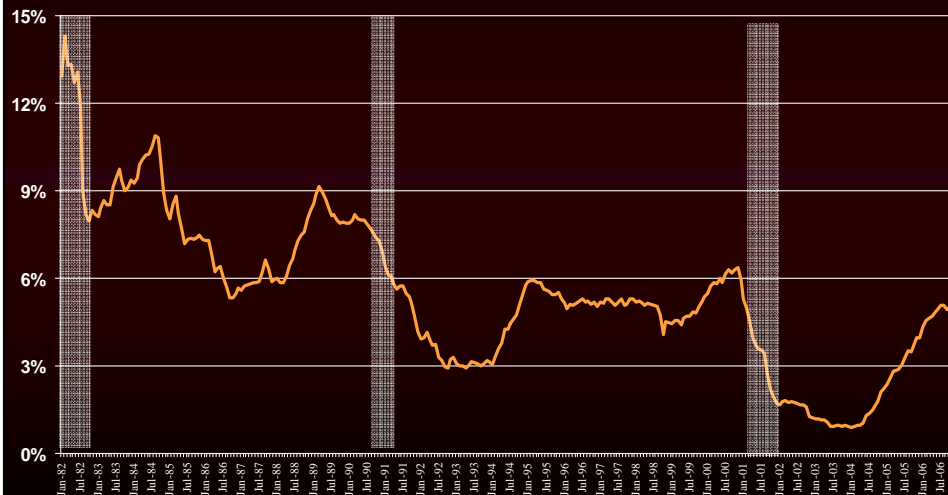


*Data through November 2006.

3-Month Treasury

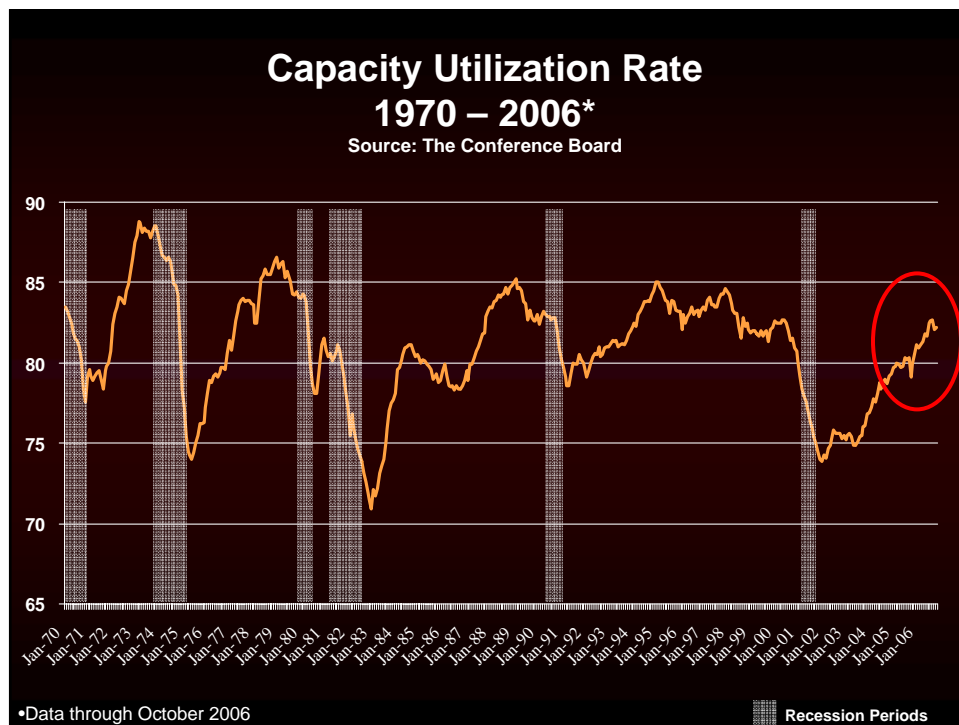
1982 – 2006*

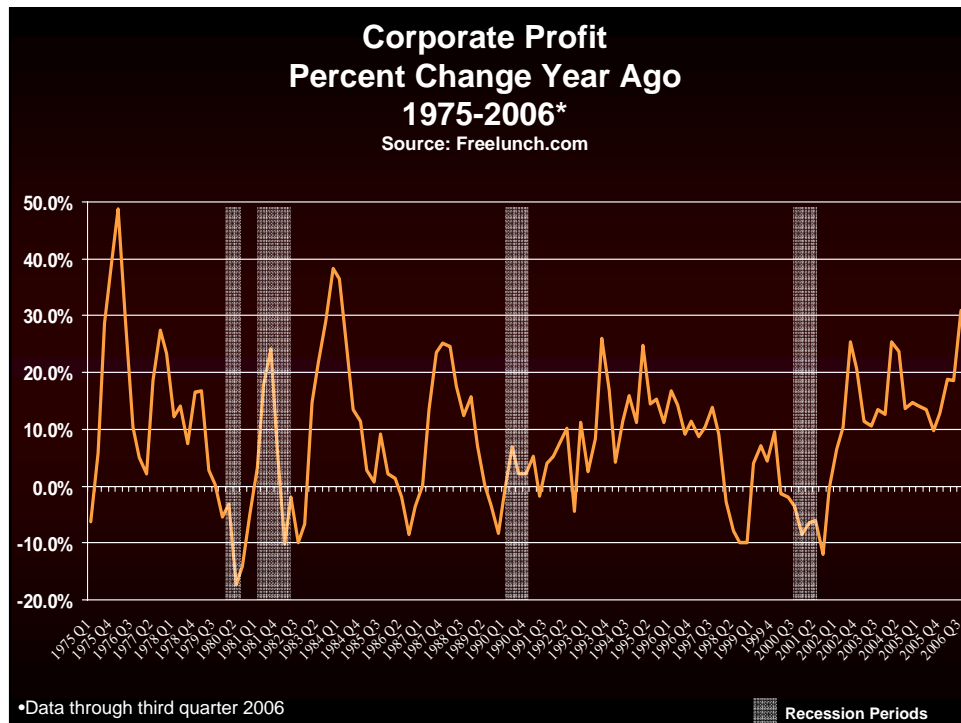
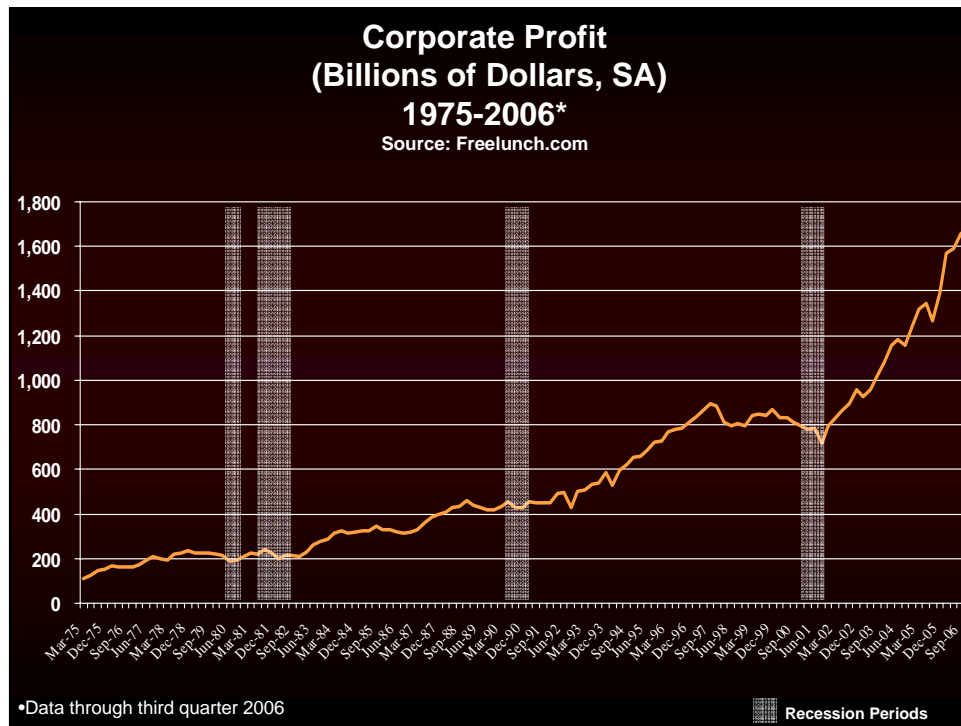
Source: Federal Reserve Economic Database



*Data through November 2006.

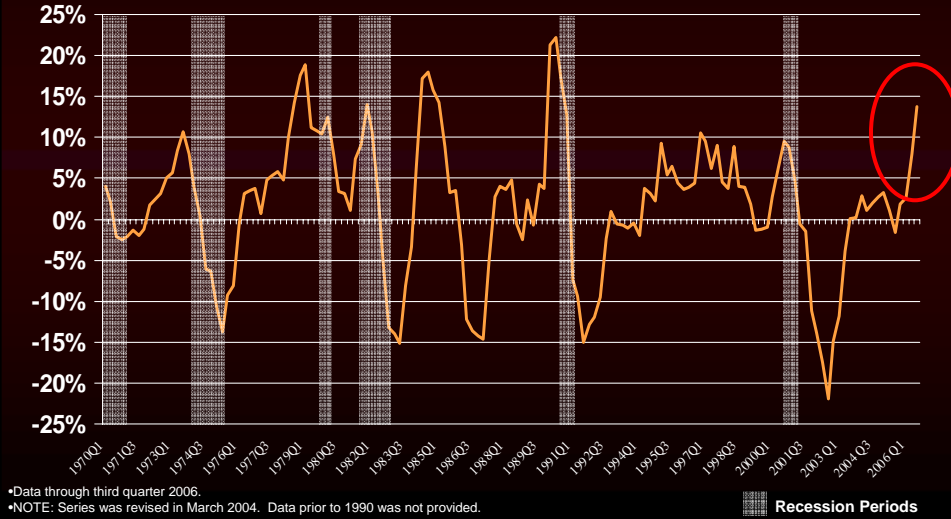
Can business pull us forward ?





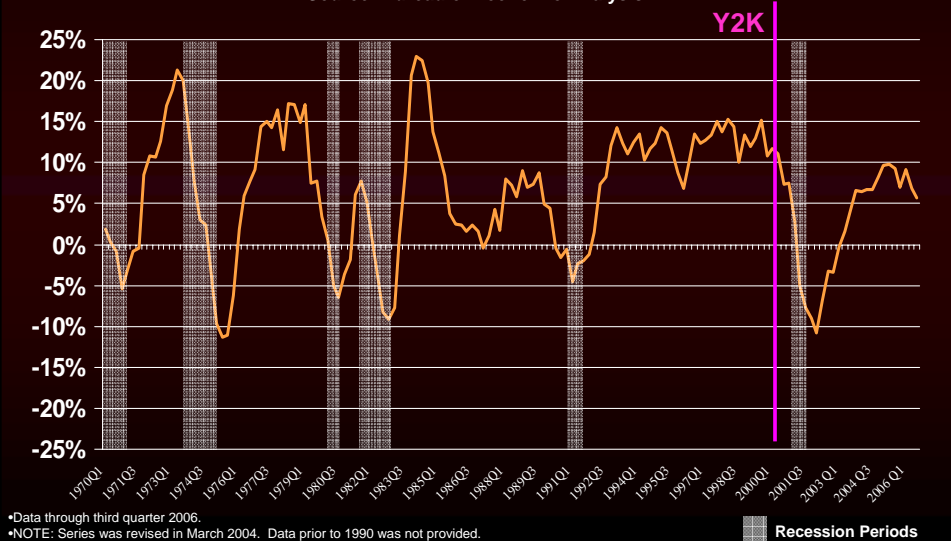
Total Plant Spending Percent Change Year Ago (Real Dollars) 1970 – 2006*

Source: Bureau of Economic Analysis



Total Equipment & Software Spending Percent Change Year Ago (Real Dollars) 1970 – 2006*

Source: Bureau of Economic Analysis



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

1991 – 2006*

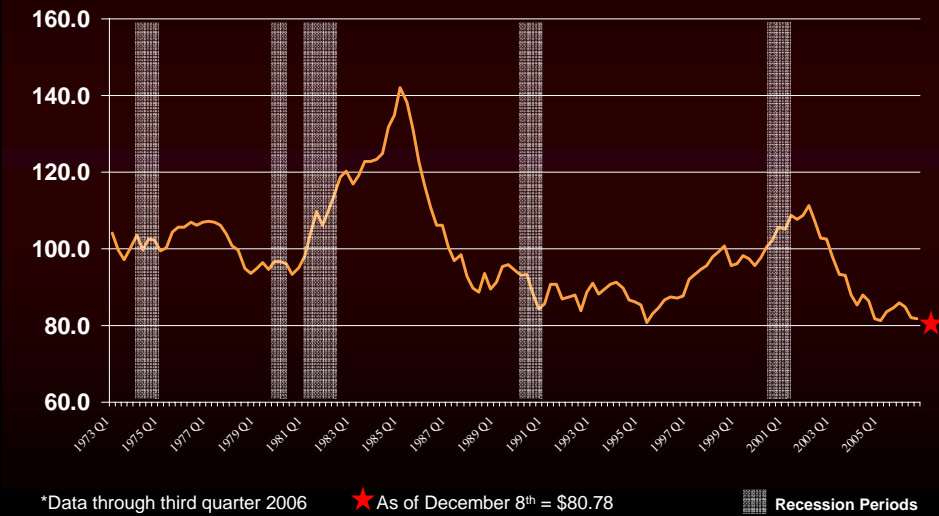
Source: Federal Reserve, Board of Governors



Trade Weighted U.S. Dollar v. Major Currencies

1973 – 2006*

Source: Bureau of Economic Analysis



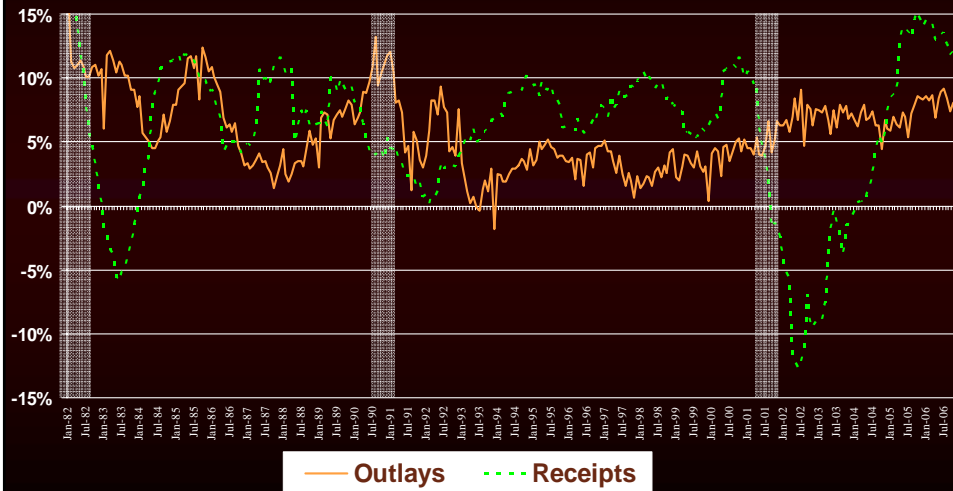
Government



**Is the federal deficit
a problem?**

Government Receipts v. Outlays Percent Change Year Ago 1982 – 2006*

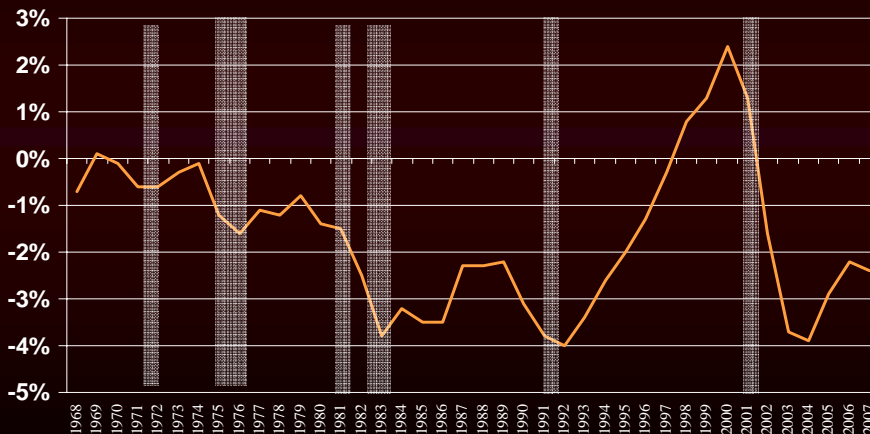
Source: Department of the Treasury



*Data through October 2006, 12-month moving average.

U.S. Federal Surplus / Deficit as a Percent of GDP 1968 – 2007

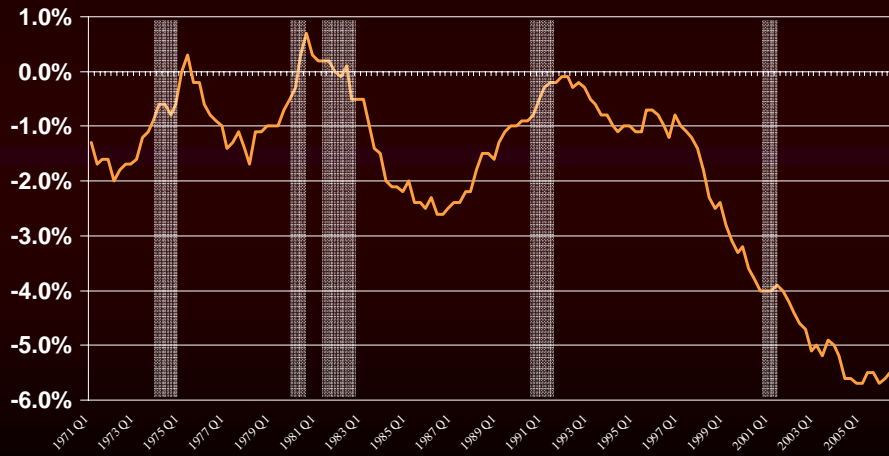
Source: White House OMB & Bureau of Economic Analysis



Note: 2007 are forecasts from the 2007 Mid-Session Review

U.S. Real Net Exports as a Percent of Real GDP 1971 – 2006*

Source: Bureau of Economic Analysis

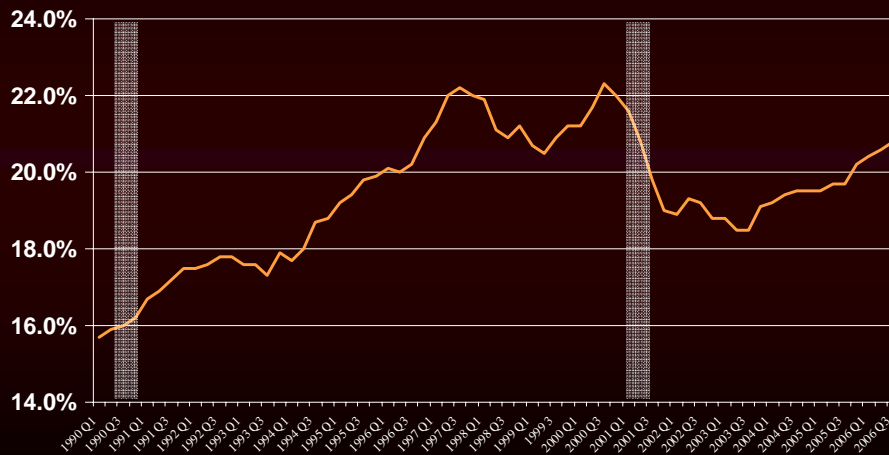


*Data through third quarter 2006

Recession Periods

Goods Exports as a Percent of Total Goods Produced 1990 - 2006*

Source: Bureau of Economic Analysis



*Data through third quarter 2006

Recession Periods

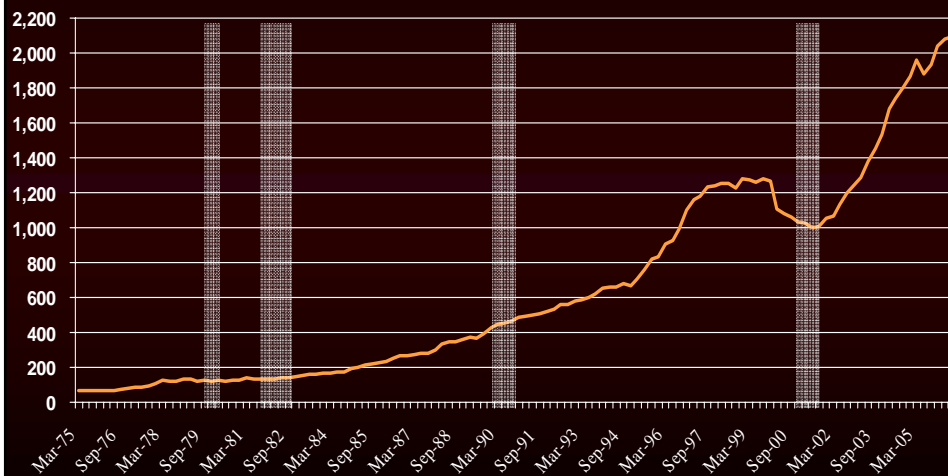
Growth in U.S. Exports As of Q3, 2006

Source: U.S. Census Bureau

<u>Country</u>	<u>2005</u>	<u>2006</u>
Canada	10.2%	9.4%
Mexico	8.0%	9.9%
Europe	8.2%	20.7%
Pacific Rim	8.7%	15.2%
Latin America	20.0%	25.7%

U.S. Debt Held by Foreign & International Investors 1975-2006* (Billions of Dollars, SA)

Source: Federal Reserve Economic Database



*Data through second quarter 2006.

Summary:

U.S. Economy...

U.S. OUTLOOK - 2007

- Consumer spending (+ / -)
- Housing (-)
- Business spending (+)
- Fiscal stimulus (+)
- Monetary stimulus (+ / -)
- Real incomes (+ / -)
- Businesses mean and lean (+)
- Productivity growth slowing (-)
- Job growth (+)
- Inflation (-)
- Low interest rates (-)
- Exports (+)



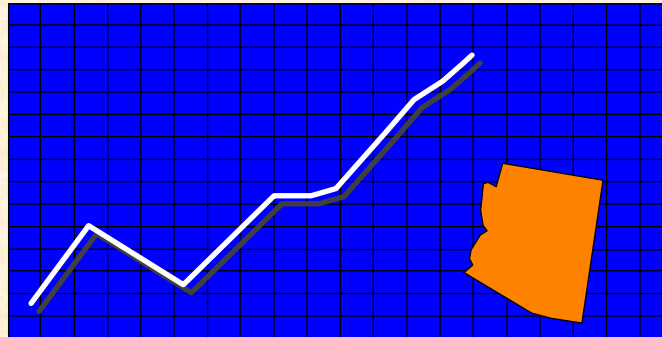
ELLIOTT D. POLLACK
& Company
Economic and Real Estate Consulting

WWW.ARIZONAECONOMY.COM

INFO @ EDPCO.COM

7505 East Sixth Avenue, Suite 100 Scottsdale, Arizona 85251
480-423-9200 P 480-423-5942 F www.arizonaeconomy.com

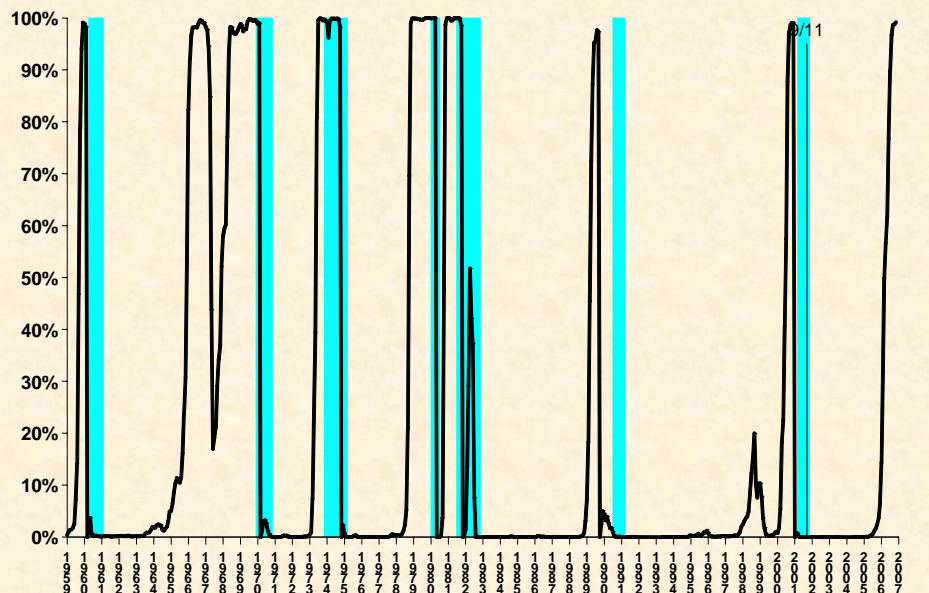
Arizona Update and Outlook



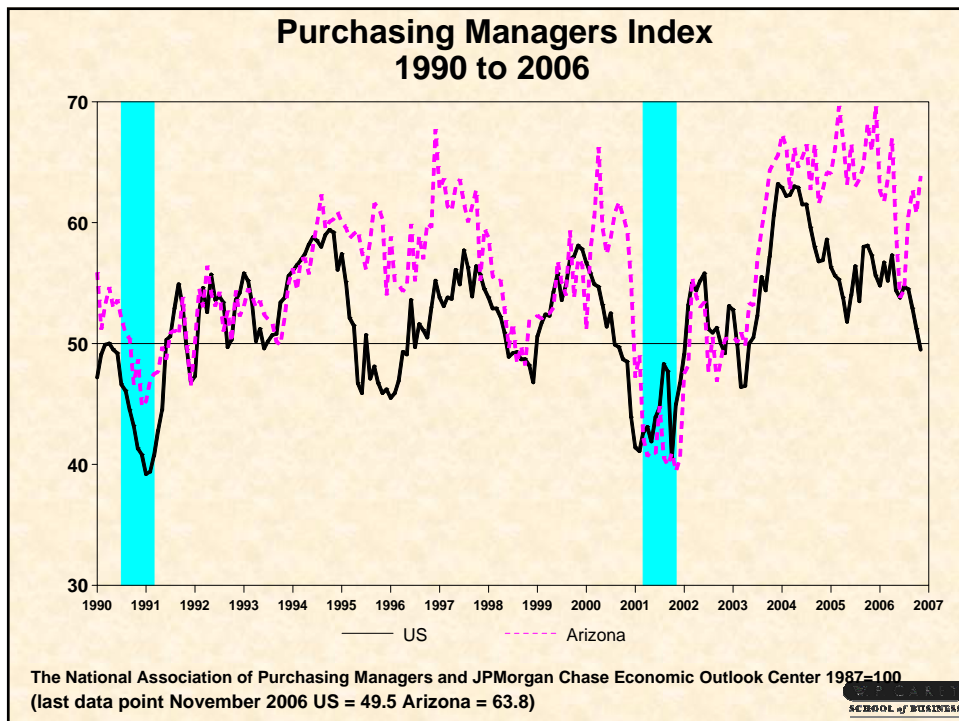
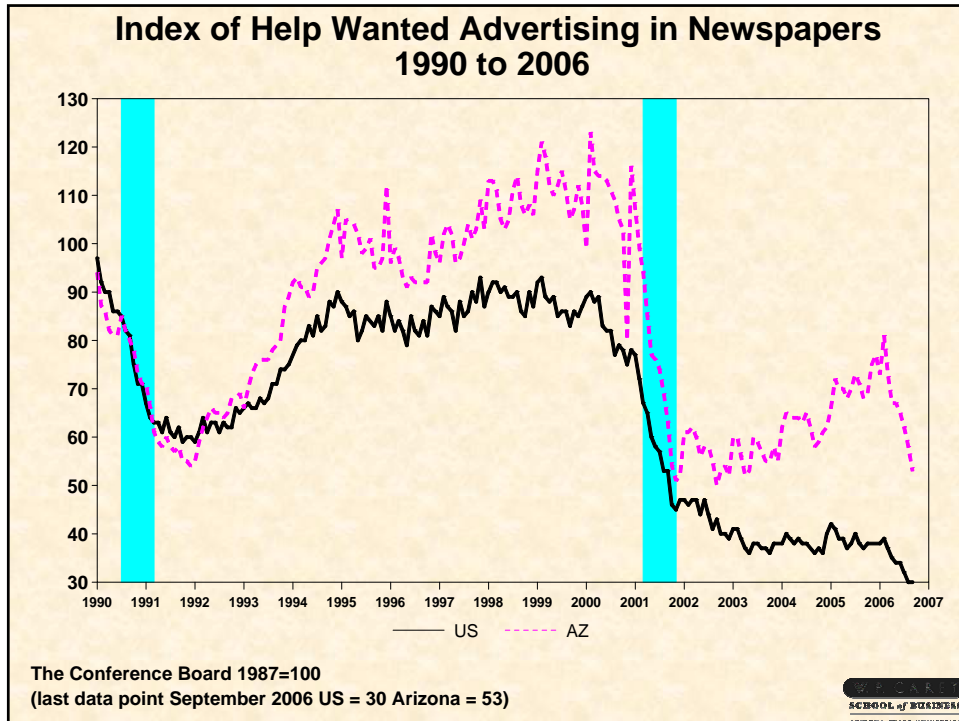
JPMorgan Chase Economic Outlook
Center

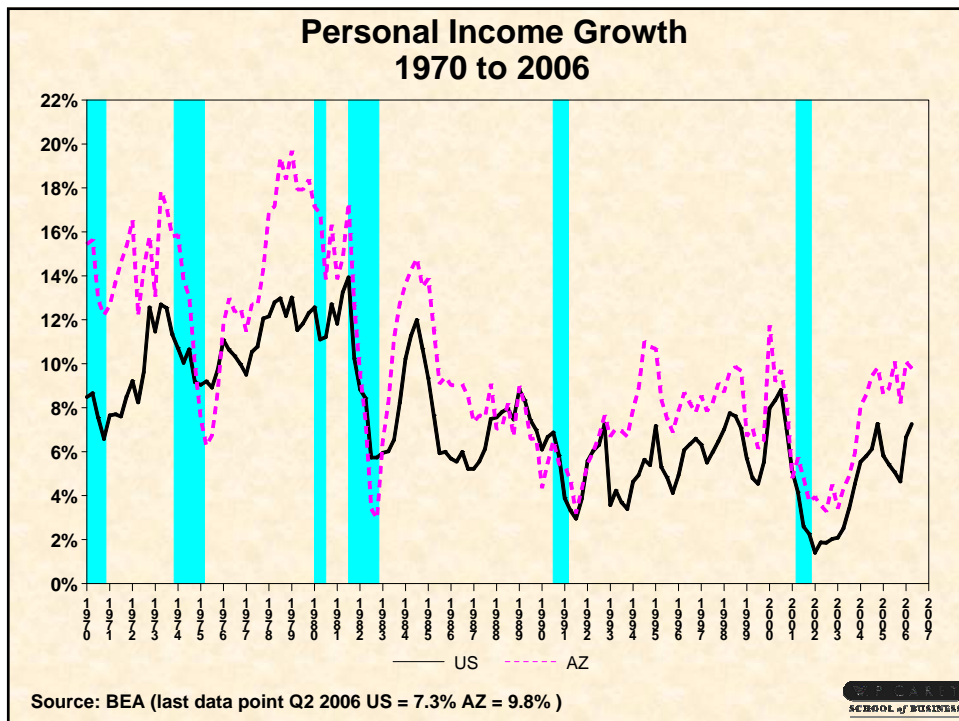
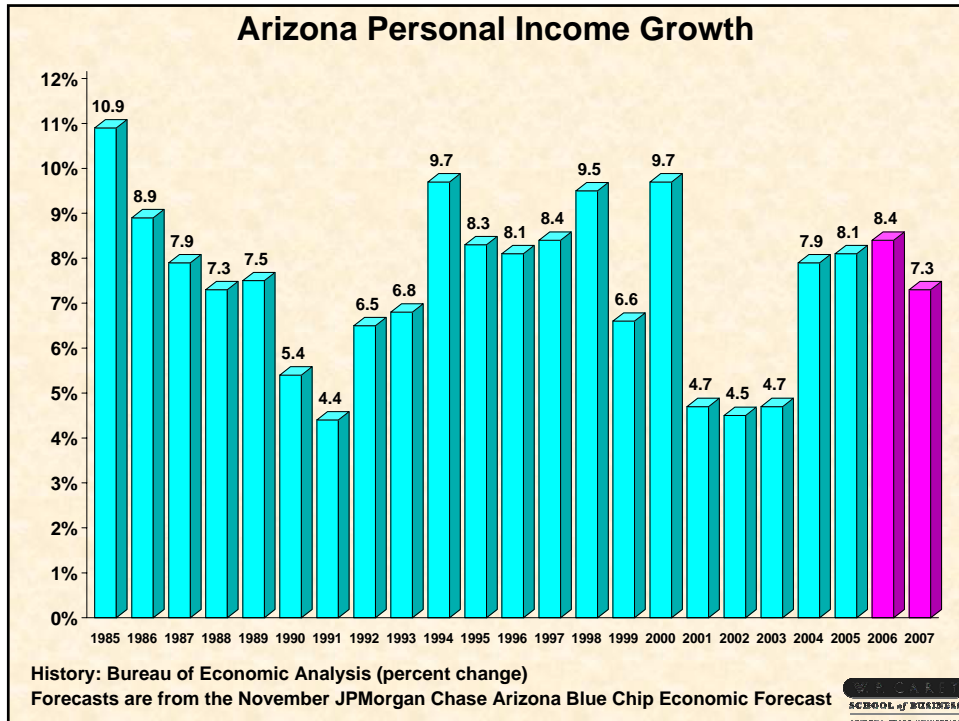
W. P. CAREY
SCHOOL of BUSINESS

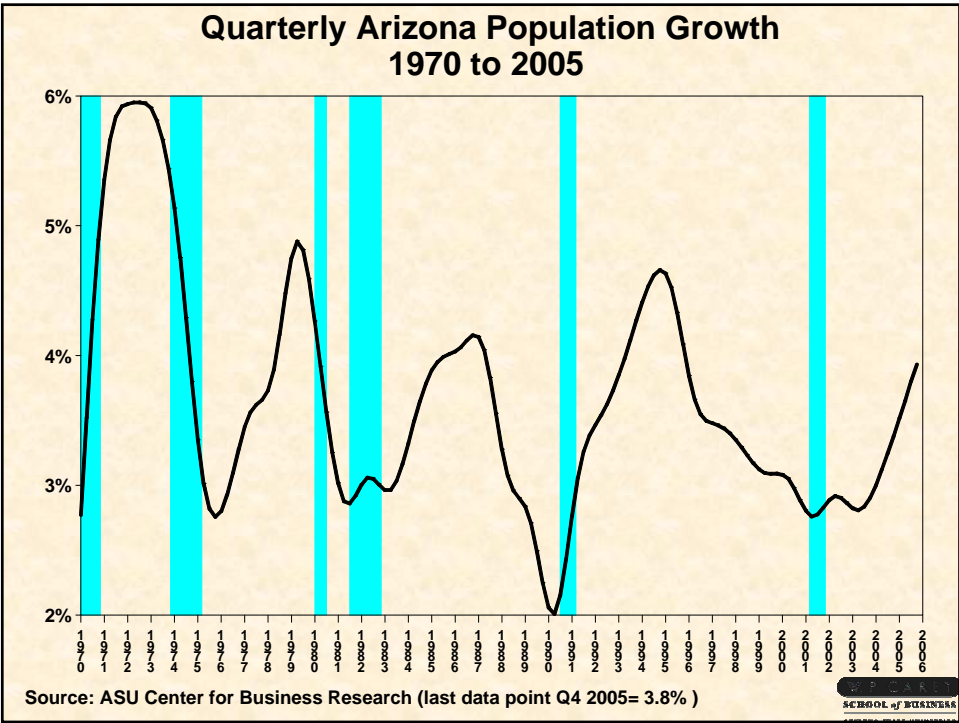
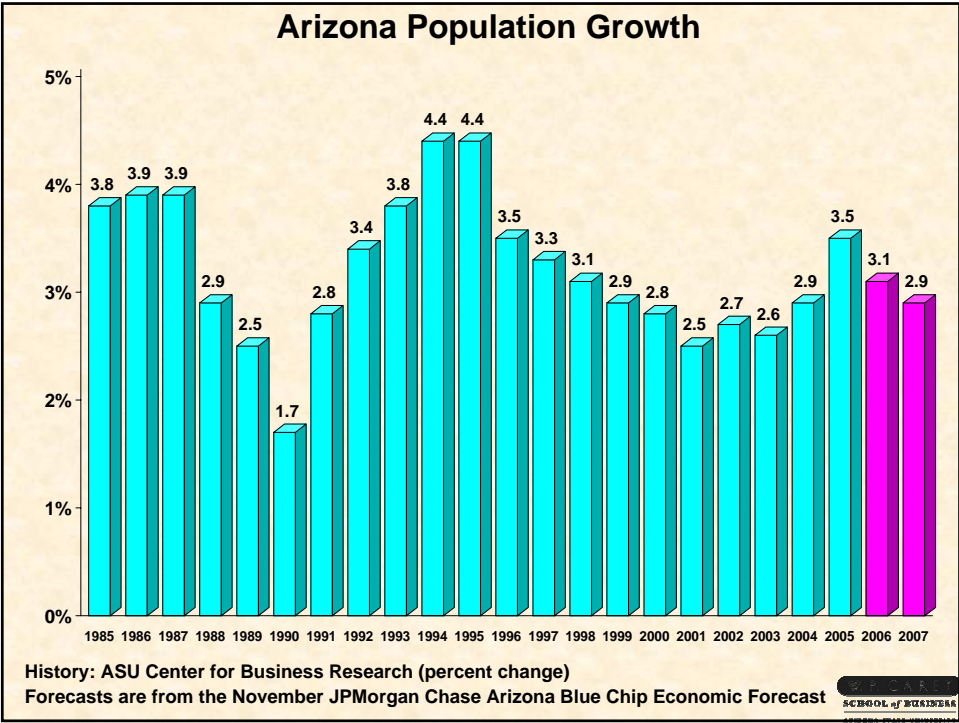
Probability of Recession from the Yield Curve (Neftci formula applied to 10 year - 1 year spread)

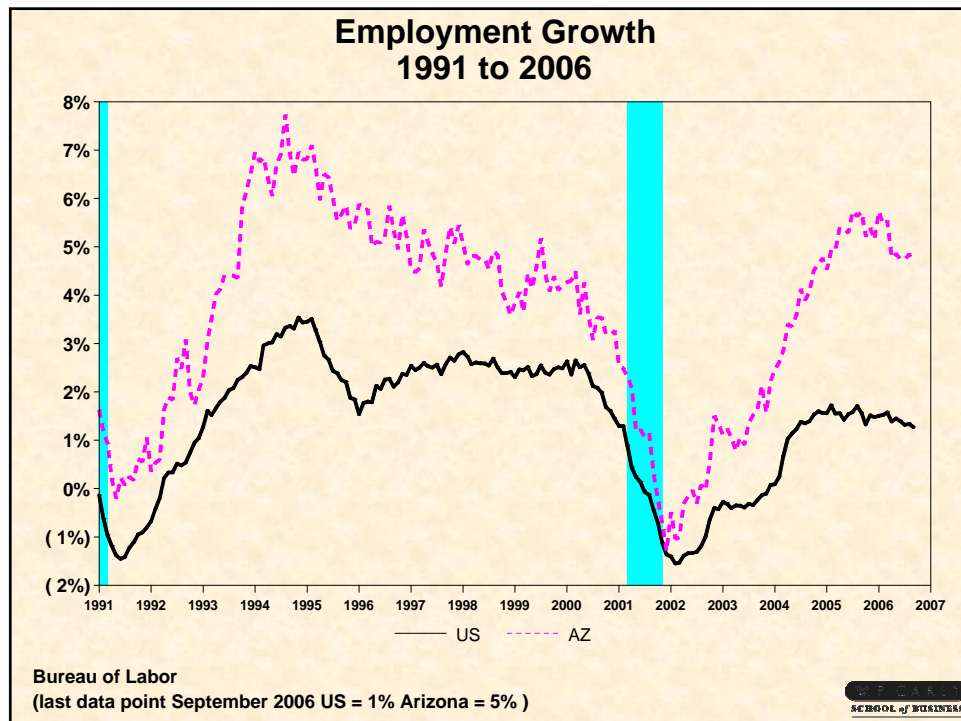
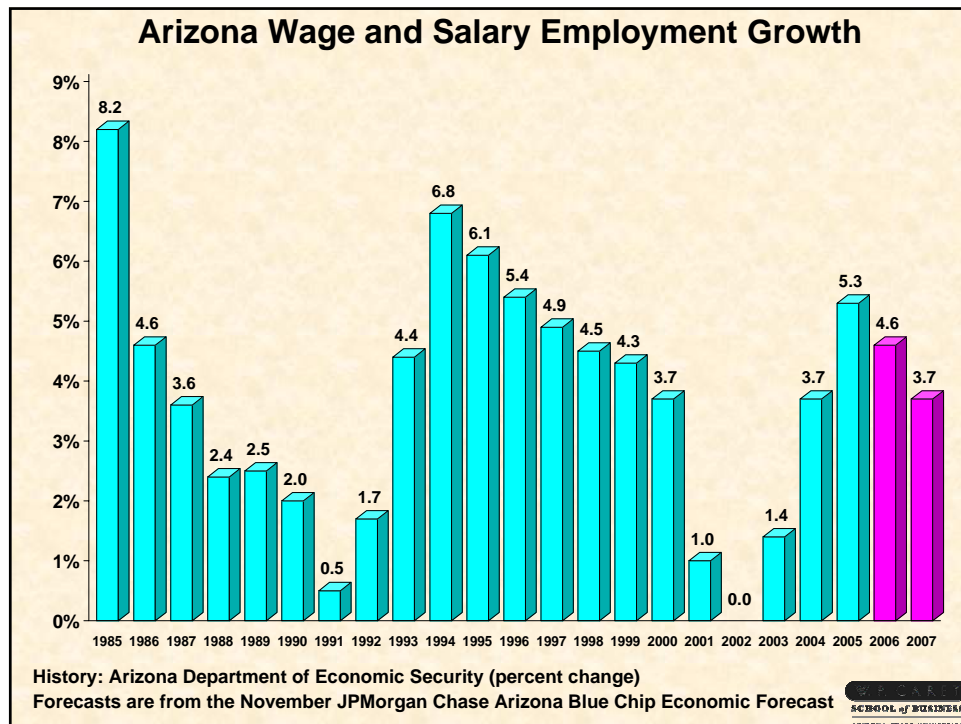


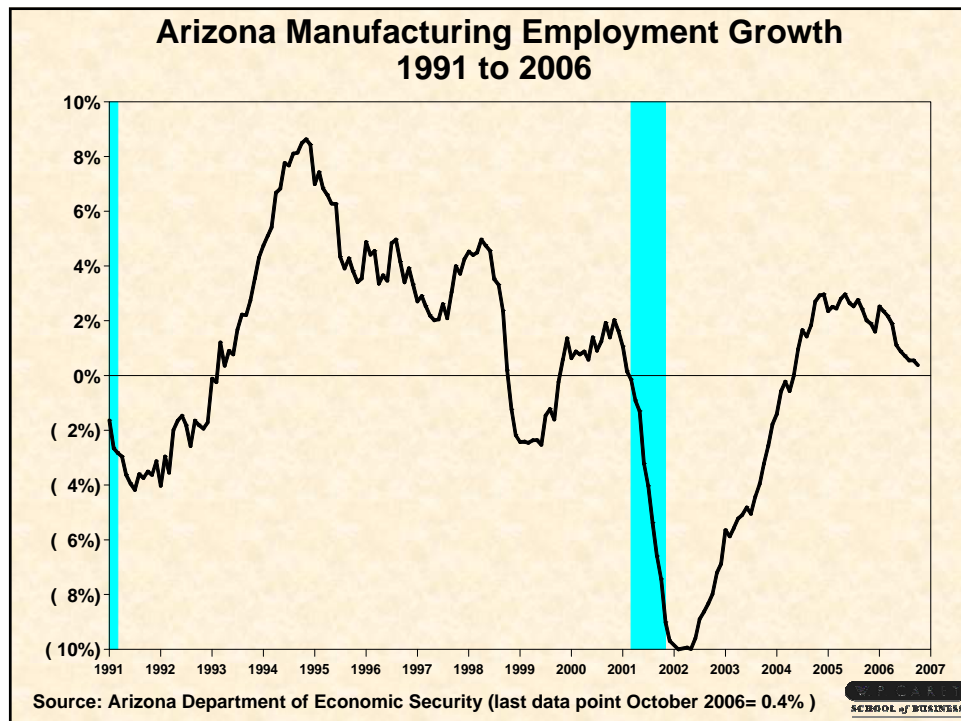
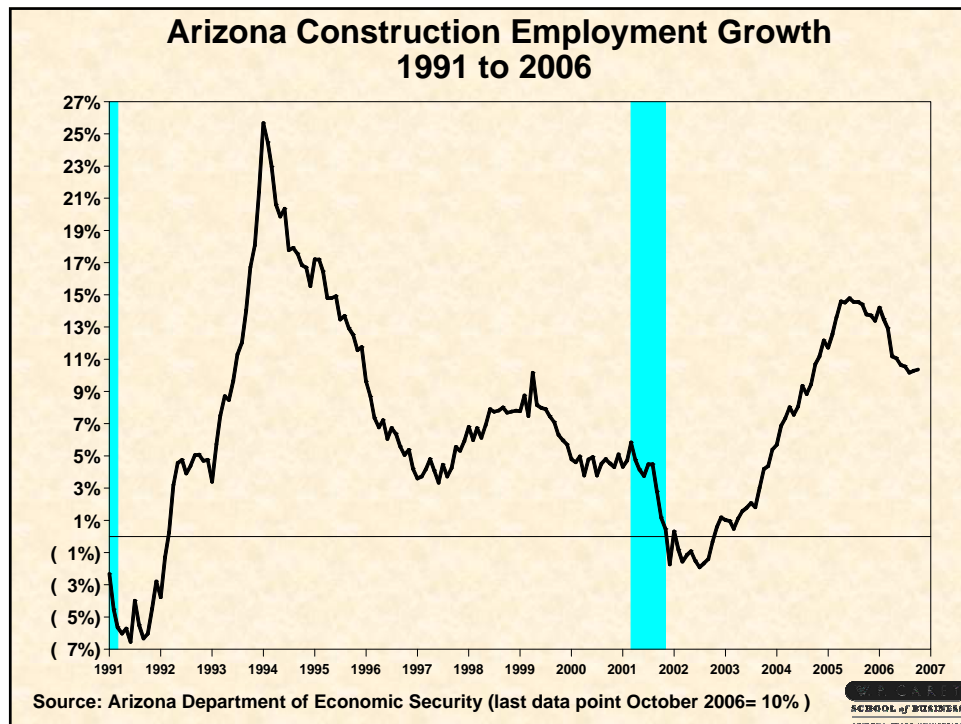
Source: JPMorgan Chase Economic Outlook Center calculations (last data point November 2006= 99%)

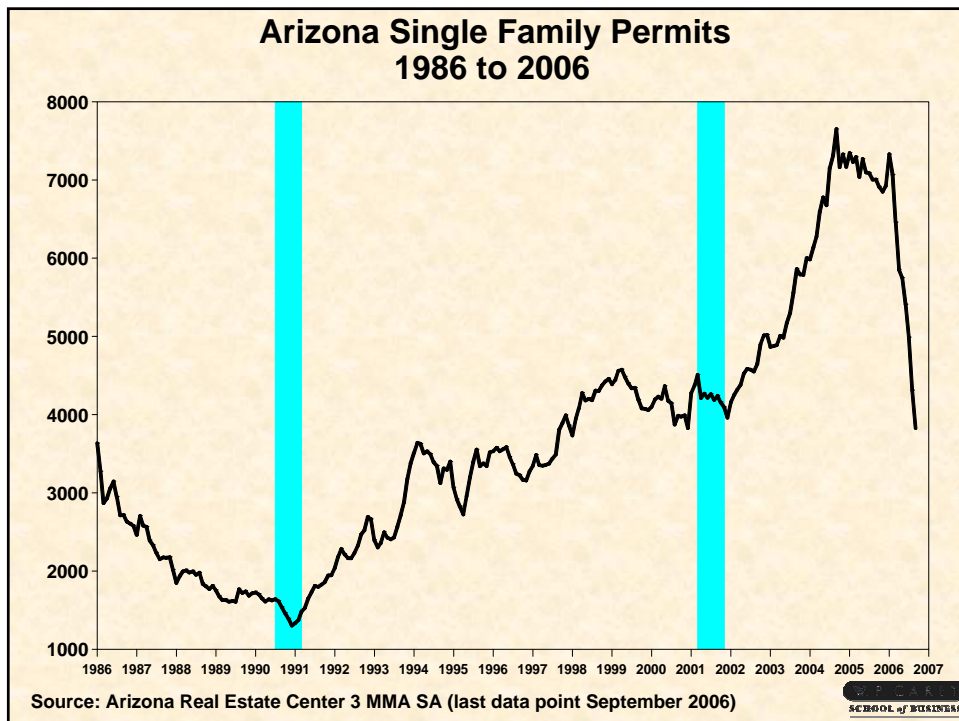
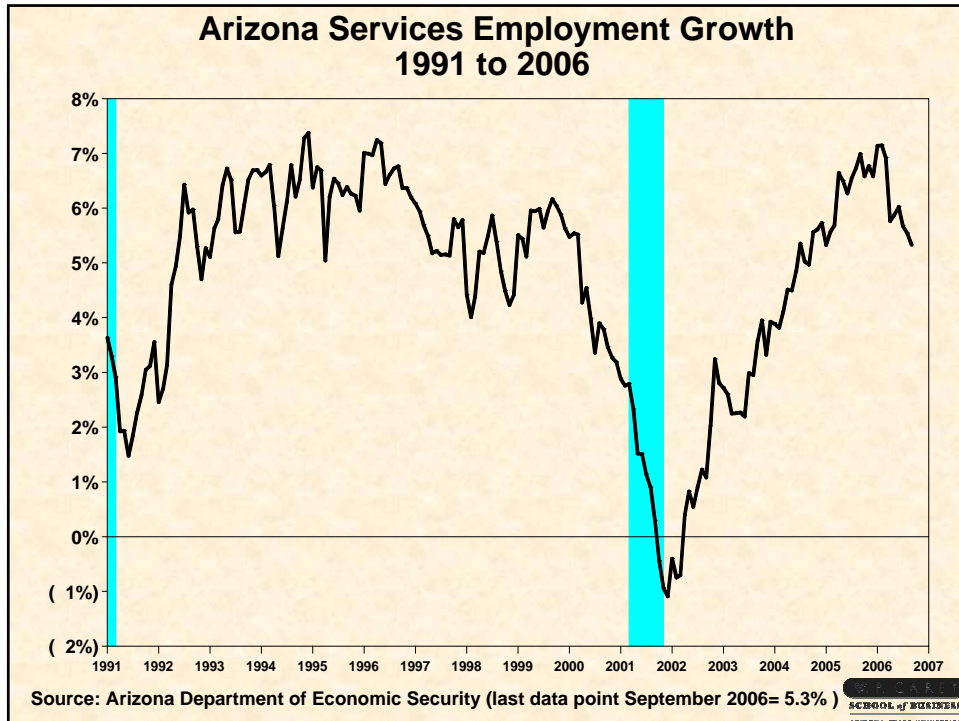


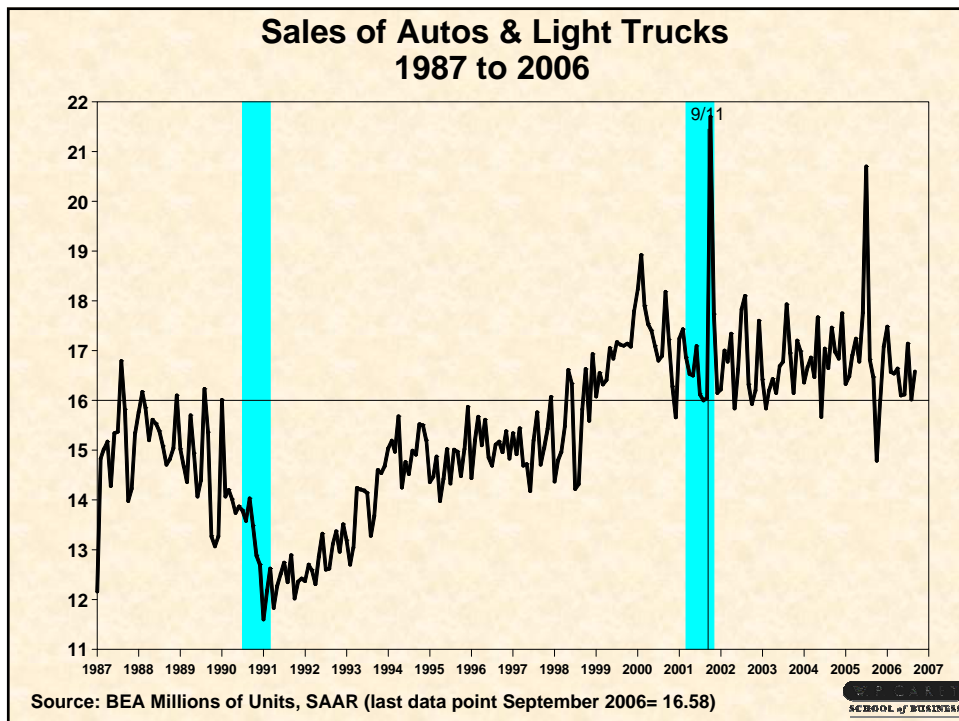
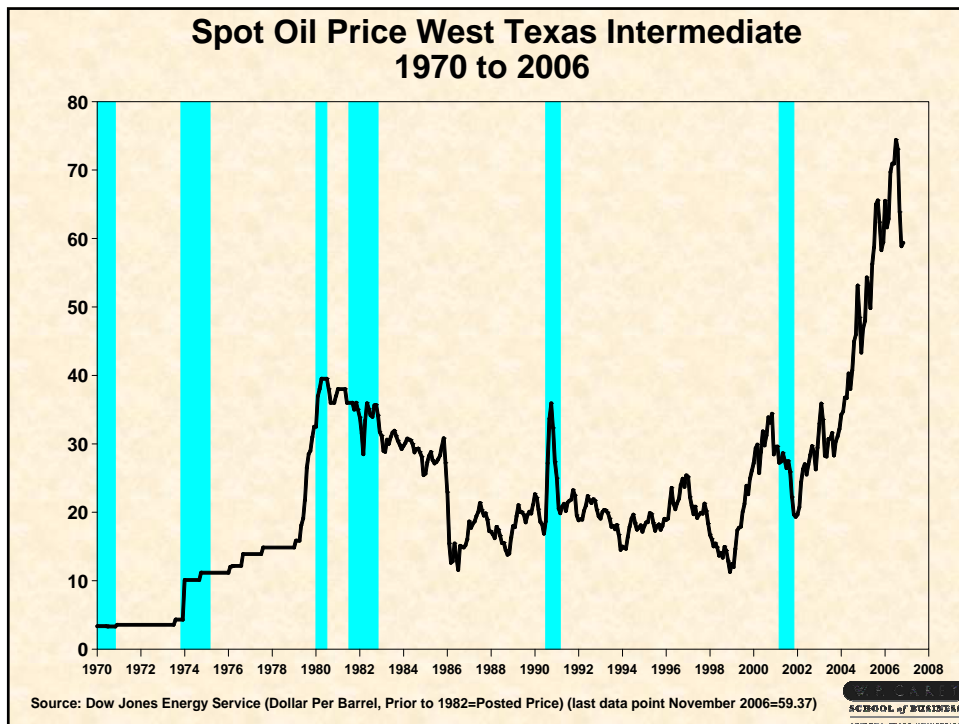


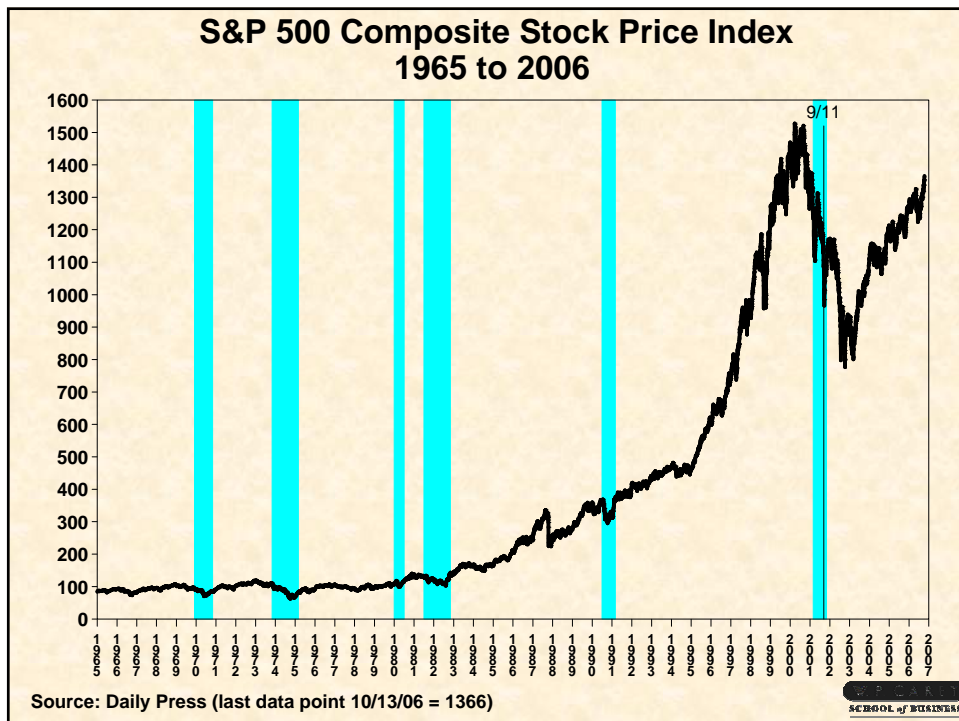
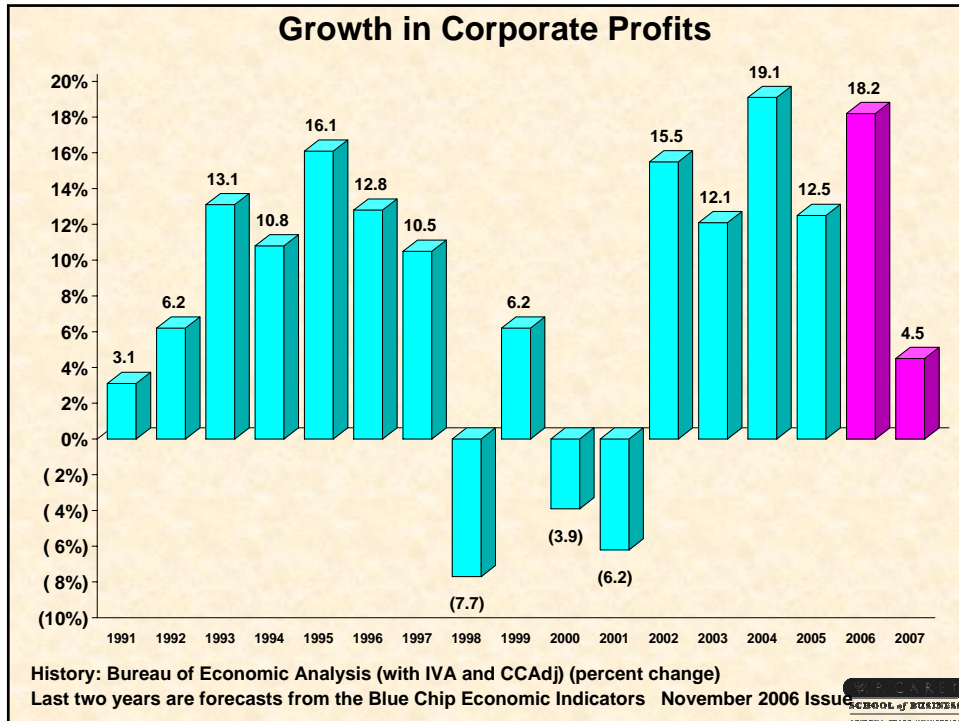












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