FINANCE ADVISORY COMMITTEE
January 13, 2009
Senate Hearing Room 1 – 9:30 a.m.

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.
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
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](http://www.azleg.gov/jlbc/meeting.htm).
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 1st 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

FY 2008 Actual = $4.3 Billion

* 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

FY 2008 Actual = $3.4 Billion

* 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.

FY 2008 Actual = $785 Million
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

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<thead>
<tr>
<th>Category</th>
<th>October 2008</th>
<th>January 2009</th>
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<tbody>
<tr>
<td>UA-Base</td>
<td>-1.5%</td>
<td>-7.4%</td>
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<tr>
<td>UA-Low</td>
<td>-5.7%</td>
<td>-10.5%</td>
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<tr>
<td>FAC</td>
<td>-5.4%</td>
<td>-10.6%</td>
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<tr>
<td>JLBC</td>
<td>-4.9%</td>
<td>-8.2%</td>
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</table>

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

<table>
<thead>
<tr>
<th>Forecast Type</th>
<th>FY 2009</th>
<th>FY 2010</th>
<th>FY 2011</th>
<th>FY 2012</th>
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<td><strong>Sales Tax</strong></td>
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<tr>
<td>JLBC Forecast</td>
<td>-6.3%</td>
<td>0.1%</td>
<td>4.3%</td>
<td>6.0%</td>
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<tr>
<td>UA - Low</td>
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<td>UA - Base</td>
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<tr>
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<td><strong>Average:</strong></td>
<td>-8.2%</td>
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<td>-7.7%</td>
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<tr>
<td>UA - Base</td>
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<td>FAC Survey</td>
<td>-9.2%</td>
<td>-0.1%</td>
<td>4.7%</td>
<td>8.5%</td>
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<tr>
<td><strong>Average:</strong></td>
<td>-7.2%</td>
<td>-2.8%</td>
<td>3.1%</td>
<td>6.9%</td>
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<tr>
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<td>-23.0%</td>
<td>-4.1%</td>
<td>13.5%</td>
<td>9.0%</td>
</tr>
</tbody>
</table>

| **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% |

Forecast percentages are prior to tax law changes.
Bail Out or no Bail Out

= a BAD year
or
a TERRIBLE year.
Credit Markets: Economics vs. Psychology

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,
10. FHA Hope for Homeowners($300B for mortgage assistance).
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

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
The Result

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

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

Source: Bureau of Economic Analysis

* Data through third quarter 2008
Consumer Spending on Non-Durable Goods & Services
Percent Change Year Ago
1971 – 2008*
Source: Bureau of Economic Analysis

3.0%
5.0%
7.0%
9.0%
11.0%
13.0%
15.0%

Recession Periods

Basic Story

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

* Data through third quarter 2008
The Result

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

Basic Story

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

Housing

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

Weakening economies are more sensitive to shocks.
How many more shoes can drop?

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

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
### Real Retail Sales U.S.
#### Percent Change Year Ago
#### 1973 – 2008*

*Source: Federal Reserve*

-5% | -3% | -1% | 1% | 3% | 5% | 7% | 9% | 11% | 13%

**Recession Periods**

*Data through November 2008

**Three-month moving average

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**Short-term:** deflation

**Long-term:** inflation
Consumer Price Index less Food & Energy
Percent Change Year Ago
1990 – 2008*
Source: Bureau of Labor Statistics

*Data through November 2008

Recession Periods

Consumer Price Index
Percent Change Year Ago
1990 – 2008*
Source: Bureau of Labor Statistics

*Data through November 2008

Recession Periods
Consumer Energy Goods & Services Spending as a Percent of Personal Income
1975 – 2008*
Source: Bureau of Economic Analysis

* Data through third quarter 2008

Oil Prices - $/Barrel
1982 – 2008*
Source: Freelunch.com

*Data through Jan. 6th 2009.
Spot Index for Raw Industrials
1967=100
January 2006 – November 2008
Source: Freelunch.com

Wealth Effect
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

*Data through third quarter 2008
**Dow Jones Stock Prices**
Percent Change Year Ago
1980 – 2008*
Source: www.economy.com

**Mortgage Equity Withdrawal**
as a share of Disposable Income
U.S.: 1971 – 2008*
Source: Bureau of Economic Analysis

*Data through January 6, 2009

* Data through third quarter 2008
Financial Obligation Ratio**
1980 – 2008*
Source: Federal Reserve

Savings Rate
1980 – 2008*
Source: Federal Reserve

*Data through third quarter 2008
**Ratio of mortgage and consumer debt (including auto, rent and tax payments) to disposable income.
Business: Finally taking it on the chin?

The extent depends on the industry…
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

*Data through third quarter 2008
Industrial Production
Percent Change Year Ago
1973 – 2008*
Source: The Conference Board

Capacity Utilization Rate
1970 – 2008*
Source: The Conference Board

*Data through November 2008
Total Plant Spending
Percent Change Year Ago
(Real Dollars)
1970 – 2008*
Source: Bureau of Economic Analysis

Recession Periods


• Data through third quarter 2008.
• NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.
National Employment
Percent Change Month Ago, Annualized (S/A)
1981 – 2008*
Source: U.S. Bureau of Labor Statistics

Hours Worked
Percent Change from Year Ago
1976 – 2008**
Source: Bureau of Labor Statistics

*Data through November 2008

**Data through third quarter 2008
Value of the dollar...

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

Source: The Federal Reserve

Recession Periods

*Data through December 2008
U.S. Real Exports as a Percent of Real GDP
1971 – 2008*
Source: Bureau of Economic Analysis

Is credit now tight?
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.

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
Percentage of Large U.S. Banks Reporting Tougher Standards on Business Loans 1997 – 2008*

Source: Federal Reserve, Board of Governors

High Yield Credit Spread 2004 – 2008*

Source: Bespoke Investment Group; Merrill Lynch

* Data as of October 2008 survey.

** The spread between high yield corporate bonds (non investment grade/below bbb rated) and comparable Treasuries.
High Yield Credit Spread
1997 – 2008*
Source: Bespoke Investment Group; Merrill Lynch

Recession Periods

*Data through October 8, 2008.
** The spread between high yield corporate bonds (non-investment grade/below BBB rated) and comparable Treasuries.

Housing Market

Foreclosure NEXT EXIT

Elliott D. Pollack & Company
### U.S. Number of Vacant Homes for Sale

**2000 – 2008***

**Source:** U.S. Census Bureau

- **Data through 3rd Quarter 2008.**

### United States Home Sales

**Months Supply – Single Family New Homes**

**2000 – 2008***

**Source:** U.S. Census Bureau

- **Data through November 2008.**
Median Price of Resale Homes – U.S.
Percent Change Year Ago
2003 – 2008*
Source: National Association of Realtors

*S Data through third quarter 2008

S&P/Case-Schiller Home Price Index** (Composite of 20 MSA's)
Percent Change Year Ago
2001 – 2008*
Source: Macro Markets, LLC

*Data through October 2008
**Measures changes in existing single family home prices given a constant level of quality.
Greater Phoenix S&P/Case-Schiller Home Price Index**
Percent Change Year Ago
1990 – 2008*
Source: Macro Markets, LLC

*Data through October 2008
**Measures changes in existing single family home prices given a constant level of quality.

How will it turn out?
U.S. Housing Rebound: Can It Start After 2009?

Total Housing Starts
Source: US Census Bureau

Home Prices Indices
2000 – 2010
Source: Macro Markets, LLC; AMLS

Recession Periods

*Data through October 2008
Tighter lending standards and a weak economy have acted as a drag on the housing market.

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
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

U.S. Summary 2009:
The first half, continued ugly.
The second half, no better than homely.
Because….

In the first half, comparisons are tough.
In the second half, comparisons get easier.
Economic Update and Outlook: Arizona

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

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
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%

Consumer Confidence Index
(1985=100)

Source: Conference Board and Behavior Research Center, Inc.
Retail Sales Components, AZ
Current Dollars, Annual Rate

Retail Sales Growth, AZ
(retail, restaurant & bar, food, and gasoline)
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%
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
Existing Home Sales, MLS
000s units, seas adj annual rate

Building Permits, AZ
(seasonally adjusted annual rate)
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 4th quarter

Business Leader Confidence Index

Arizona
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%

Annual Change in Pop & Jobs

Arizona

[Chart showing annual change in population and jobs from 1980 to 2015]
Indicators To Watch

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

Visit Our Award-Winning Website:
EBR.Eller.Arizona.edu
State Budget
& Cash Flow Crisis

January 13th 2009
FY09 Year to Date Collections (-11.48%) : $7,884,224,238

FY09 Treasurer's Forecast (-13.66%) : $7,674,721,550

FY09 Budget Revenue Forecast (2.95%) : $9,171,181,700

Spending in the 1st half of FY09: $5.24 billion, $28 million per day

50% of Fiscal Year
Where is the money going?
% Change in “slice of the GF pie”

Fiscal Years 1999-2009