The HdL Companies
(909) 861-4335

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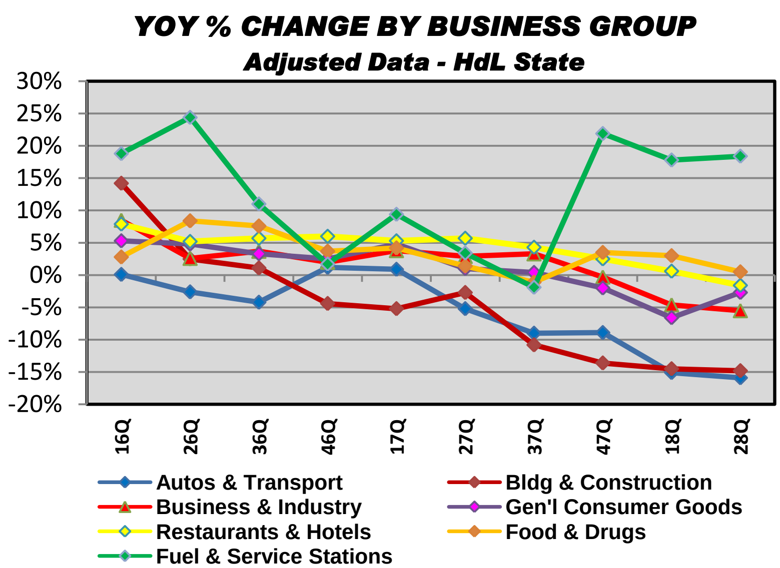
TO: **HdL CLIENTS**

SUBJECT: **SALES TAX AND THE ECONOMY**

September's sales tax receipts for sales occurring April through June continued to contract from 2007 levels. The auto and building/construction groups exhibited another quarter of double digit declines. General consumer goods, restaurants and business to business sales also decreased after adjusting for one-time reporting aberrations. The losses were partially offset by another quarter of record tax gains from fuel and service stations.

Each jurisdiction's sales tax revenues will perform differently depending on the make-up of its specific tax base and surrounding conditions. On an overall basis however, State Controller John Chiang has reported that the state's fiscal year-to-date cash collections of sales tax are 4.0% below last year's and predictions for the remaining fiscal year are becoming increasingly pessimistic.



The federal "rescue" program to deal with the financial crisis is designed to keep an already dismal credit problem from getting worse and is not expected to significantly change the sales tax trends that were developing before the crisis reached the proportions of the past week. It had already been concluded from September's unemployment and manufacturing data that the nation is moving into a recession.

The following is a brief summary of what analysts are currently predicting based on their evaluation of government and trade association data generated through September 2008.

Autos and Transportation

Californians registered 18.3% fewer new car purchases in the first half of 2008 versus a year earlier. This was a steeper drop than the 10.1% decrease for the U.S. as a whole. The demand for small, fuel efficient cars as opposed to fully loaded gas guzzlers also significantly reduced the taxable values of the cars that were sold. Trade data for September reports the lowest sales month since 1993 despite some of the largest discounts ever given on previously popular sports utility vehicles and pickup trucks.

In terms of sales tax, previous forecasts on when the decline will "bottom out" have become less optimistic. Unless there is drastic change in consumer sentiment, we don't see the decline leveling off until 2009. However, performance among jurisdictions will vary with the specific mix of brands and dealer management.

Some jurisdictions will experience additional hits because of dealership closures. The California New Car Dealers Association estimates that seventy of their 1400 members have already closed their doors this year and many manufacturers are offering incentives to encourage more to shut down and consolidate in order to strengthen the remaining dealers and free up funds for advertising and investment. The credit crisis is expected to accelerate closings in 2009 particularly among the domestic brands.

Various manufacturers, auto analysts and the California New Car Dealers Association are concluding that there is not enough pent up demand for a significant recovery from the bottom of the decline to occur until 2010 or later. This will be the first year that manufacturers will be tooled up to offer new models of fuel efficient autos. Also, even if the immediate problem of credit unavailability is resolved, many potential vehicle shoppers are unable to finance new purchases because they are currently tied to long term loans on vehicles whose resale values are now less than the outstanding loan amounts.

Building and Construction

Roughly ten percent of the State's sales and use tax revenues come from building related materials and supplies and much of that is tied to home improvements and/or home construction. California has experienced double digit declines in this source of sales tax for four full quarters but as non-residential construction normally lags residential construction by five to eight quarters, we may not have yet fully bottomed out.

Although non-residential construction spending has remained solid to now, the American Institute of Architects has reported a dramatic drop off in design activity for future projects. Many builders of commercial and industrial properties are either putting plans on hold or having difficulty obtaining financing. Even with the Federal rescue plan, the collapse of investment banks is expected to place pressure on financial institutions to liquidate holding of commercial real-estate debt which suggests future discounting on the sale of office buildings, strip malls, hotels and other commercial real estate. Lower returns and tighter credit could translate into fewer new construction projects which would than translate into reduced demand for construction related materials and supplies.

In California, institutional spending on hospitals, schools and public facilities has been holding up well and the $43 billion in previously approved bonds for public construction projects should help offset anticipated declines in commercial and industrial projects in many regions. Agencies with major retailers of concrete, electrical and plumbing supplies will benefit most.

However for the state overall, major gains in building related sales tax revenues appear to be unlikely for several years. Although short sales and foreclosures are resulting in an uptick in home sales, supply still exceeds demand and additional distressed sales are anticipated. Housing prices in overbuilt markets are expected to continue to decrease into mid-2009. Past experience is that the federal rescue program will not offer immediate relief. It took three years for the market to bottom out after the Resolution Trust Fund was set up in 1989 to handle that decade's bad loans from the savings and loan crisis.

Home owners are less prone to do major home improvements when the values of their homes are declining and the current inventory of available housing is not expected to shrink to the point where significant new construction investment is attractive until after 2010.

Business and Industry

Up until the current quarter, sales tax revenues from this group as a whole, have exhibited modest but steady gains. Companies selling equipment and supplies to the petroleum, education and health services sector have provided steady revenues. The devaluation of the dollar has made sales tax from companies supplying manufacturers/exporters of semiconductors, information & energy technology, commercial aircraft & parts and agricultural products particularly strong.

The collapse of the financial system on top of a previously, slowing of the global economy has heightened concerns that some of California's biggest overseas markets in Europe and Asia are going into recession. September's index of manufacturing activity, which is maintained by the Institute for Supply Management, was the lowest since 2001 and has added to concerns of a general slowdown.

Although there will be an inventory of back orders to fill, a slowing in demand for U.S. manufactured goods is expected and will reduce manufacturers/exporters need for capital purchases and supplies. This in turn should result in a corresponding decline in related sales tax revenues.

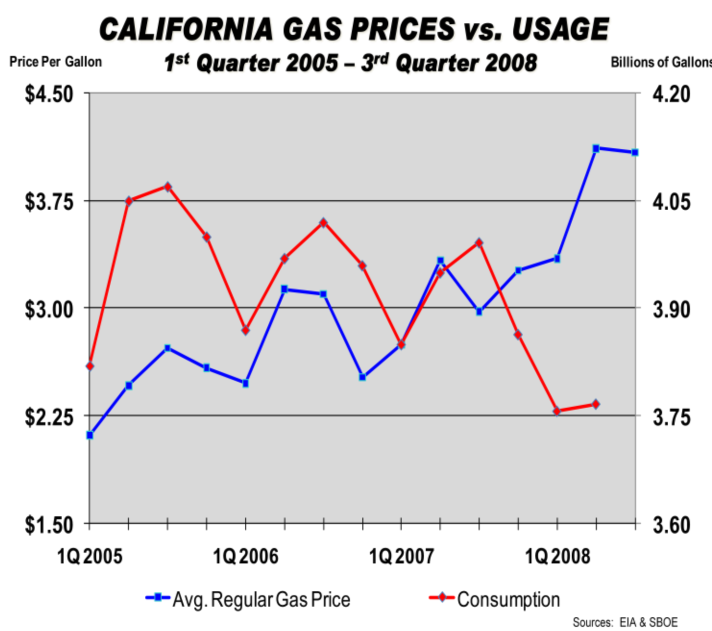
Food and Drugs

Sales tax revenues from this group tend to be closely related to inflation and population changes and are expected to exhibit modest gains over the next few quarters. The recently announced acquisition of Longs Drugs by CVS may impact some agencies if CVS elects to consolidate competing outlets that share the same market area.

Fuel and Service Stations

Fuel prices and corresponding sales tax revenues hit a new high in the second quarter of 2008 even though demand and usage continued to drop. The Energy Information Administration is predicting that demand will continue to decline for the rest of 2008. In an attempt to maintain $100 barrel prices, OPEC has recently cut back production quotas to 2007 levels to offset what they predict will be declining demand resulting from a slowdown in the global economy.

Weather, world events, refinery disruptions and market manipulation will continue to make prices for this group subject to extreme fluctuations. But overall, sales tax revenues are not expected to exceed the peak experienced during the April through June sales period. The delayed tax allocation schedule should produce continued quarter to quarter sales tax gains in revenues for the next two quarters but a leveling or decline after that.



General Consumer Goods

State wide sales tax receipts from this group's April through June sales were down 2.7% from the same quarter one year ago. August and September retail data from various government and trade sources reported continued sluggishness with retailers expressing disappointment in the important back to school buying season despite the extra revenues from the federal tax rebate stimulus.

Warehouse Clubs and value discount chains appear to be doing well as more and more consumers "shop down" to lower priced goods. Consumer electronic products also continued to show mixed gains as flat screen TVs become increasingly affordable and the popularity of IPods and other devices continue. Furniture, traditional department stores and the previously recession proof sellers of luxury goods are doing poorly. Nordstrom, Neiman Marcus, Tiffany and others in the high end category are all predicting downturns in Christmas sales.

California's seasonally adjusted unemployment rate hit 7.7% in August. This, coupled with declining wealth from decreasing values of property and investment portfolios, plus the tightening of lending standards has resulted in increasingly gloomy retail sales predictions. Forecasts from research/consulting firms Deloitte LLP and TNS Retail Forward Inc. are predicting the weakest retail gains since 1991. The National Retail Federation is projecting gains of 2.2% for November and December compared to last year's holiday season which would be lowest since 2002. UCLA and other forecasters see California's economy to be weaker than the nation as a whole and overall sales performance to be lower.

Analysts predict that discount superstores, warehouse clubs, dollar stores and consumer electronics will continue to eke out modest gains through the holiday season. Sales of home related goods, apparel, gift cards and department stores are expected to decline. A shakeout in under-performing outlets and chain stores is expected in the spring. Circuit City, Borders and Talbots are considered to be particularly vulnerable.

Revenues from consumers will vary with each jurisdiction's specific mix of retailers and overall market characteristics. Agencies with new retail projects coming on line could be partially or entirely buffered from losses in same store sales. In the majority of cases however, expect revenues to be flat or down.

Restaurants and Hotels

Many casual dining chains and dinner houses are suffering from discretionary spending cuts as would-be patrons cut costs by switching to less expensive fast food chains or by dining at home. The National Restaurant Association's performance index for the first six months of 2008 reports the lowest six-month average in the six year history of the index.

The Federal Reserve observed a lowering of Southern California's tourist activity in August which could reduce receipts in areas where tourist trade is an important part of the restaurant market. Generally, revenues from this group are expected to show flat or only modest growth over the next few quarters.

THE BOTTOM LINE

A downturn in the economy has been anticipated for some time and most local agencies projected their 2008/2009 sales tax revenues accordingly. However, the current finance/credit turmoil and ensuing panic adds a new level of uncertainty that will take months to sort out. In most cases, the downturn has been more severe than previously anticipated and the decline is expected to stretch out longer than was predicted just a few weeks ago. In the end, the economy is still about people and bad news tends to compound cutbacks in consumer spending and business investment.

HdL suggests that agencies wait until they receive their December sales tax receipts before doing their mid-year budget revisions. There should be more solid data to better estimate the "bottom" of the downturn and more information on what impact the current financial crisis/rescue has on sales tax revenues. HdL will be providing at that time, individual revisions based on the latest data available and on your specific conditions and market characteristics.

In the meantime, elected officials should be forewarned that a recovery in 2009/2010 sales tax revenues is unlikely. Significant recovery in the auto and building industries is not expected until well into 2010 and most economic forecasts see continued sluggishness for California's economy for the next 12 months. Forecasts from such groups as UCLA Anderson include growing unemployment and declines in personal income which translates into fewer sales tax transactions.

A more basic long range question is the psychological effects on consumers when the economy does recover. A small group of economists are arguing that we are actually at the end of a six year spending bubble that was encouraged by lower taxes, cheap credit and unrealistic gains in home equity values. As one economist put it, "the golden age of excess spending well may be at an end."