

FINANCE ADVISORY COMMITTEE MEETING

Thursday, March 1, 2001

AGENDA

9:00 C 9:15	Elliott Pollack Elliott D. Pollack and Company	U. S. Economy
9:15 C 9:30	JLBC Staff	Revenue Outlook
9:30 C 9:45	Tracy Clark Arizona State University	Arizona Economy
9:45 C 10:00	Dan Anderson Arizona Department of Economic Security	Arizona Employment
10:00 C	Discussion	

TABLE OF CONTENTS

Page No.

REVENUE OUTLOOK (TAB 1)

Revenue Outlook Discussion..... 1

REVENUE HIGHLIGHTS (TAB 2)

January Revenue Highlights 13

ECONOMIC SUMMARIES (TAB 3)

U.S. and Arizona Economic Indicators 15

January Arizona Blue Chip Forecast..... 16

February WEFA Executive Summary..... 22

SUMMARY OF FAC MEETING ON NOVEMBER 20TH (TAB 4)

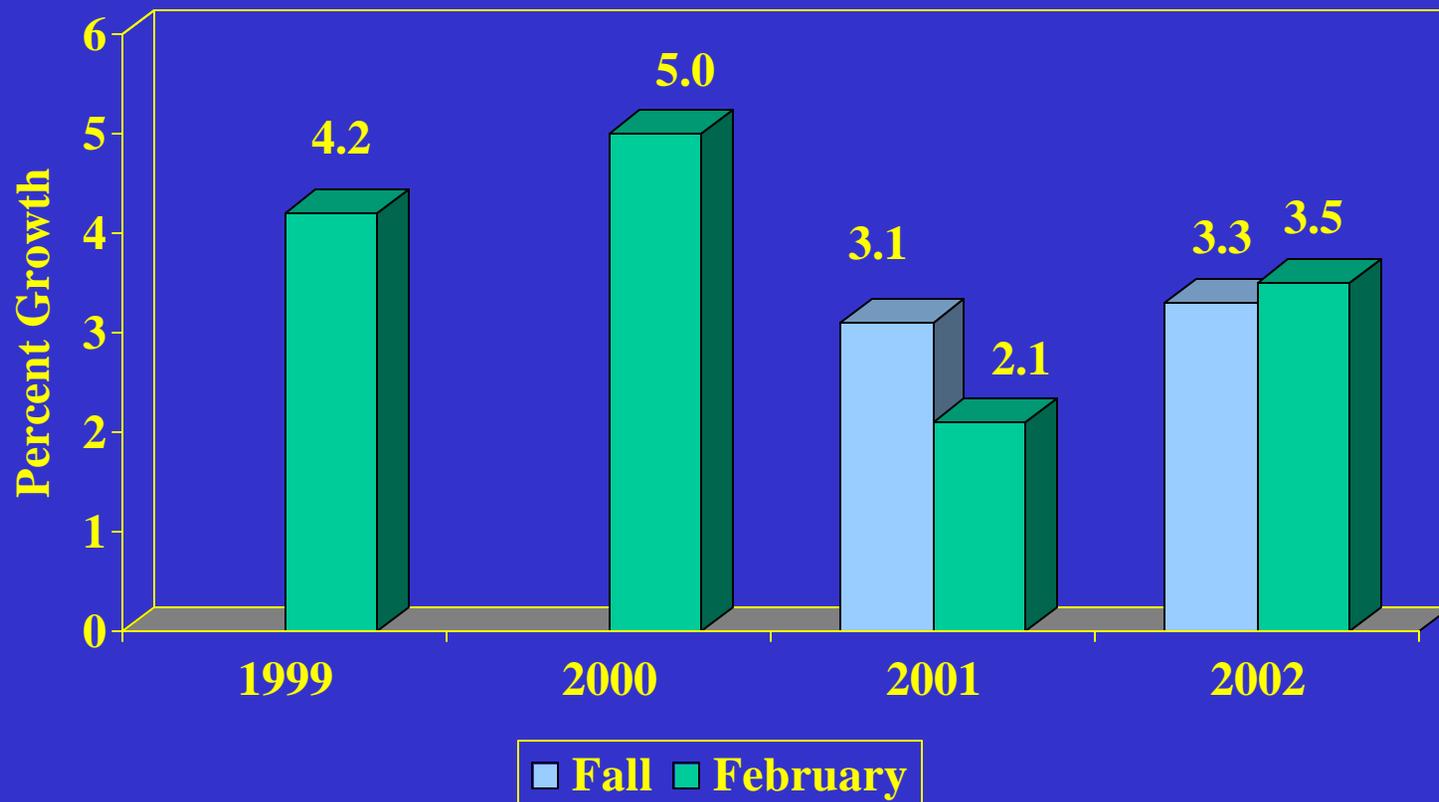
November Finance Advisory Committee Meeting Minutes..... 37

Finance Advisory Committee

March 1, 2001

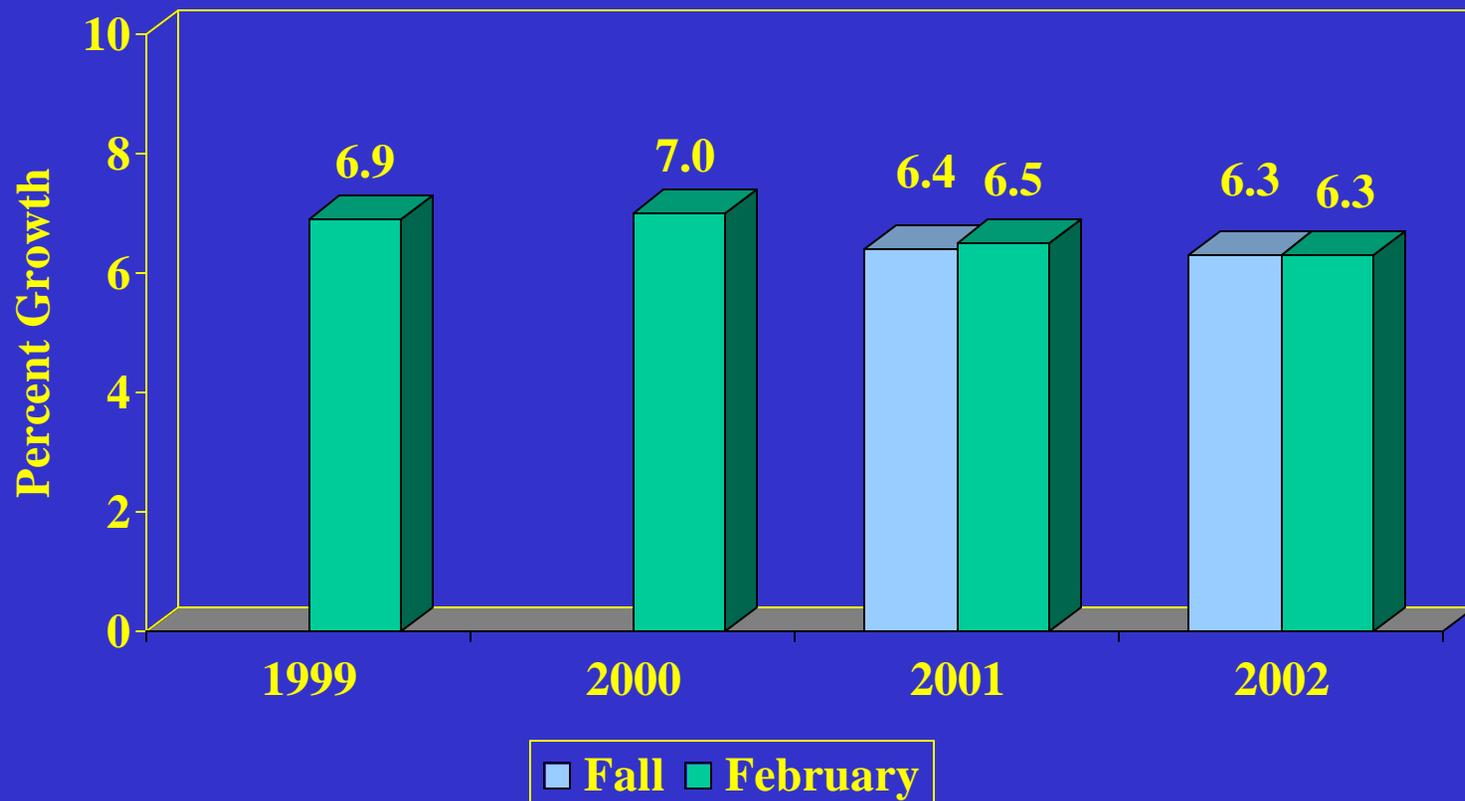
JLBC

National Real GDP Growth



Source: Blue Chip Economic Indicators

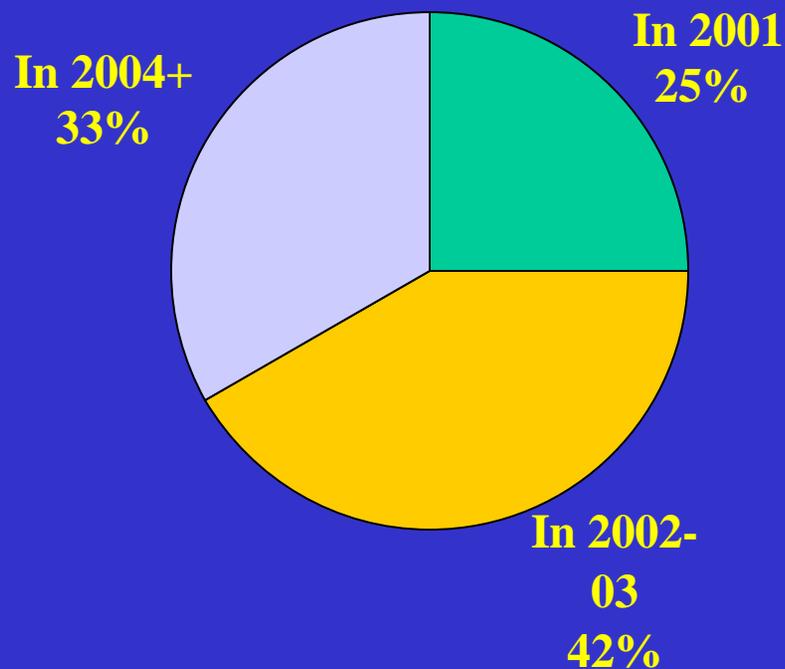
Arizona Personal Income Growth



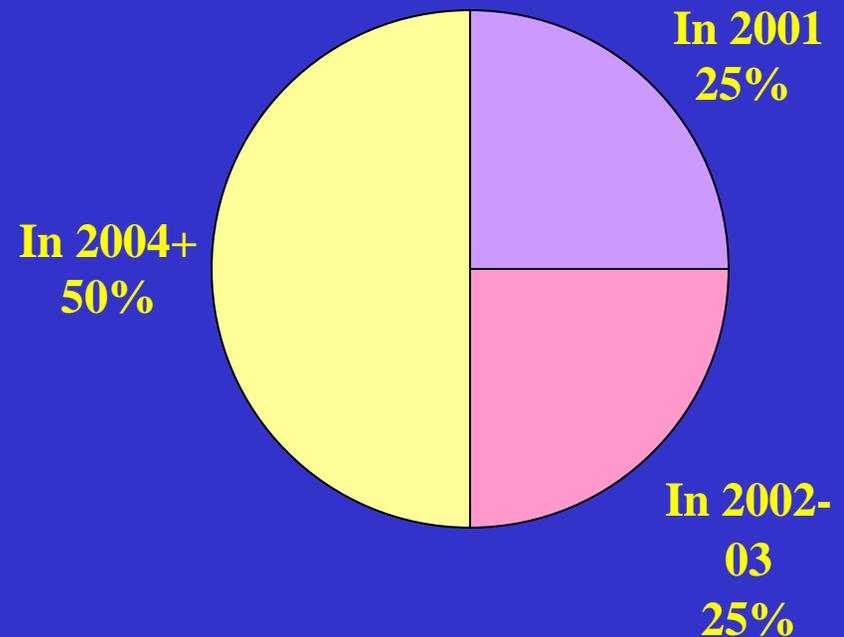
Source: Arizona Blue Chip Forecast

Arizona Blue Chip Forecast: More Optimistic About AZ Than U.S.

When Will the Next U.S. Recession Begin?



When Will the Next Arizona Recession Begin?

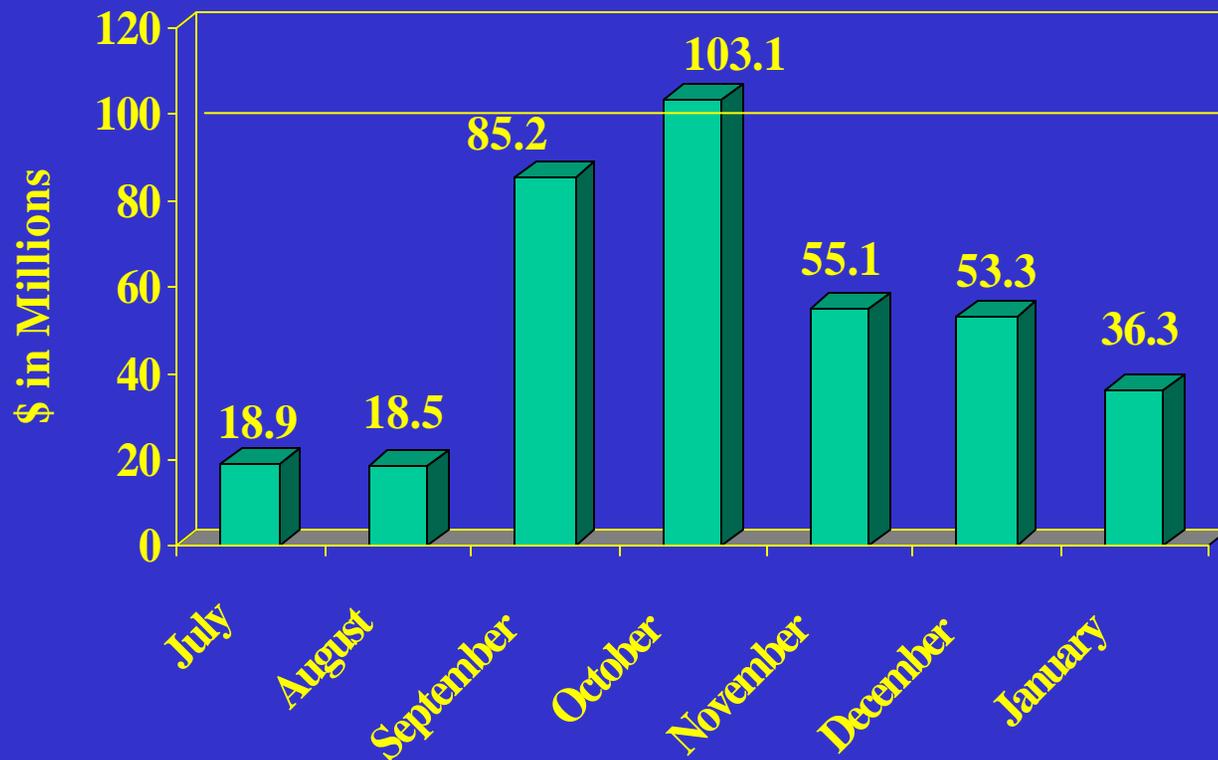


Source: Arizona Blue Chip Forecast

YTD Revenue Gains Above Original Forecast

Sales	\$ 8.5 M
Individual Income	\$(24.9)M
Corporate Income	\$ 42.9 M
All Other	<u>\$ 9.8 M</u>
Total	\$ 36.3 M

Cumulative FY 2001 Revenue Above Original Budget Forecast



← To reach the January forecast, revenues must finish \$100.7 million above the original budget forecast.

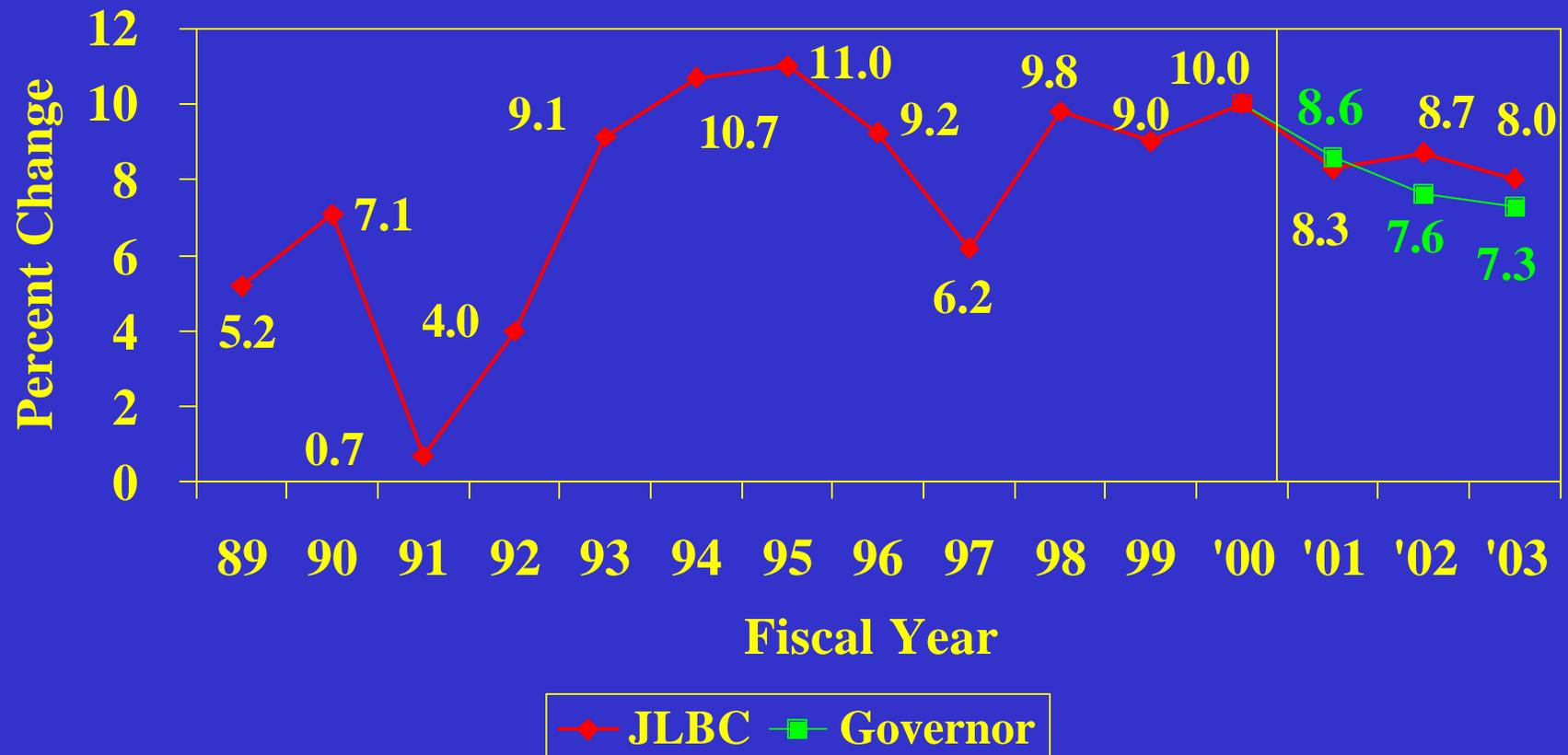
General Fund Revenues

Growth Rates Needed to Reach January Forecast

	<u>Year to Date</u>	<u>Remainder of Year</u>
Sales	6.9%	9.8%
Ind. Income	7.0%	14.2%
Corporate	20.8%	(24.3)%
Total *	6.7%	7.2%

* Represents forecasted overall net revenue growth of 6.9%
Baseline (pre-tax change) revenues projected to grow 8.3%

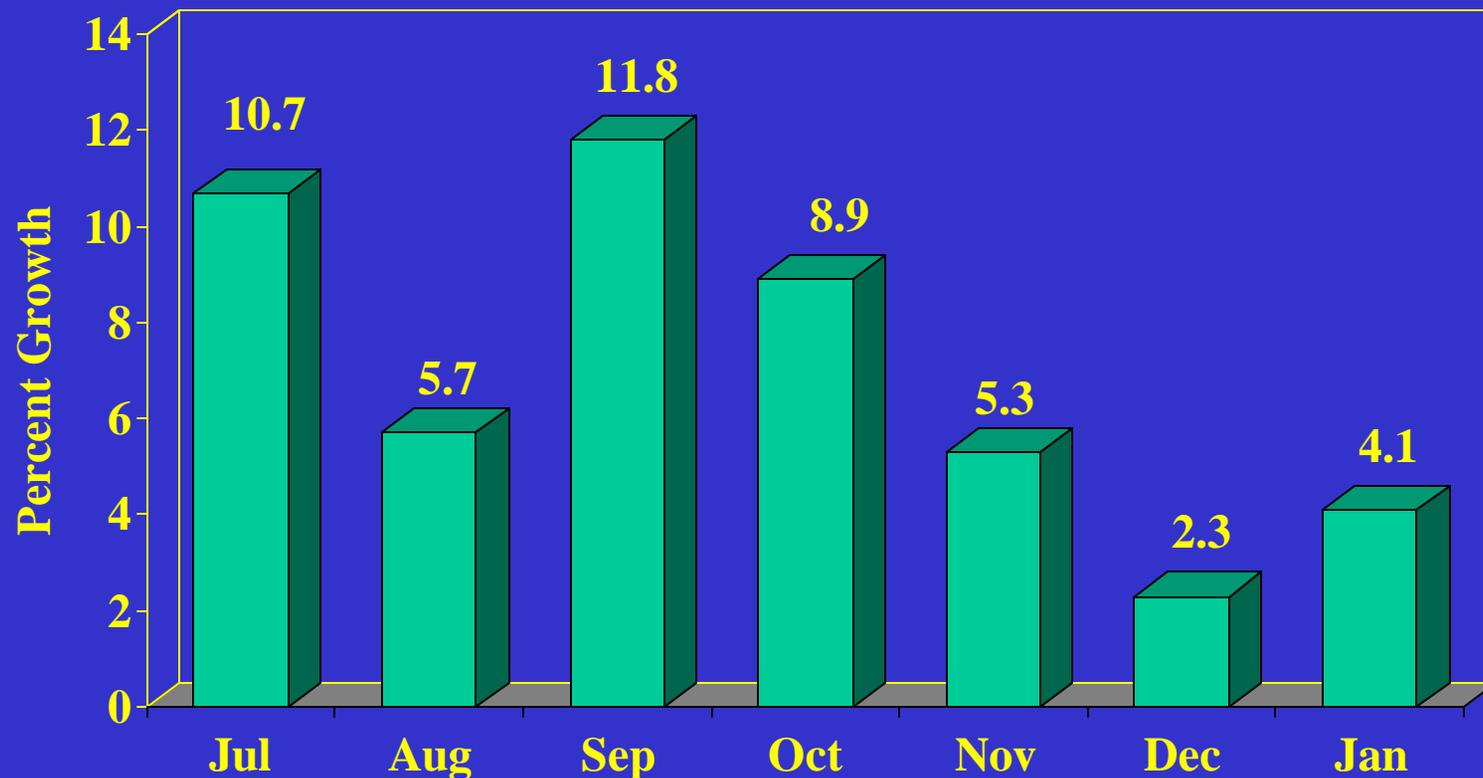
Sales Tax Baseline: 9% + Growth Since FY 1993 With 1 Exception



Sales Tax Growth Has Slowed Noticeably In Recent Months

- Over the past 3 months, average monthly sales tax growth has slowed to 3.9%, down from average growth of 9.3% for the first 4 months of FY 2001.
- Cumulative year-to-date growth is 6.9%, compared to JLBC budget year-end forecast of 8.1%.
- Our forecast calls for a resumption of robust sales tax growth. JLBC budget has a baseline growth of 8.7% in FY 2002 and 8.0% in FY 2003.

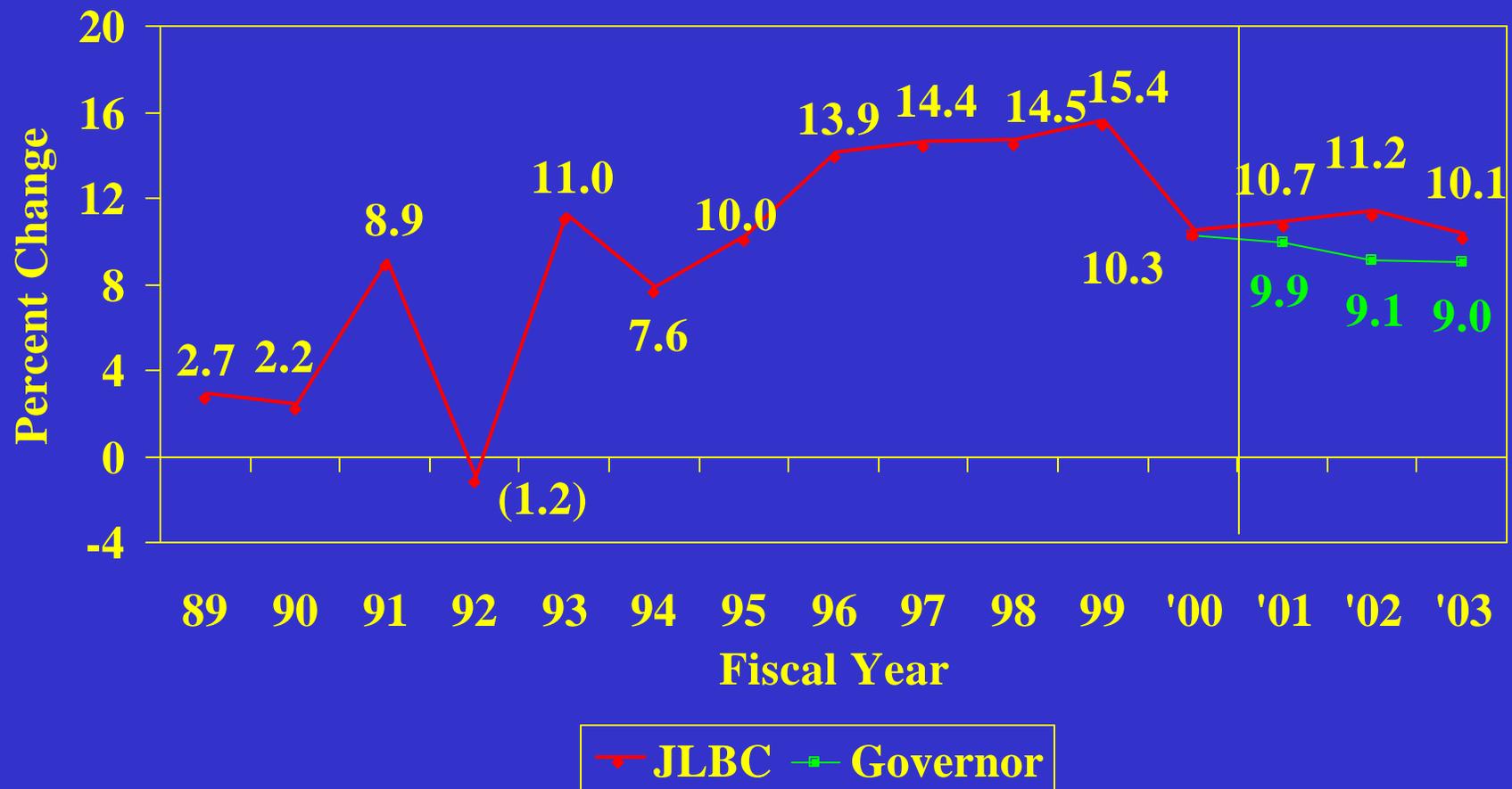
Monthly Net Sales Tax Growth



YTD: 6.9% Annual Forecast: 8.1%

*** Over same month in prior year**

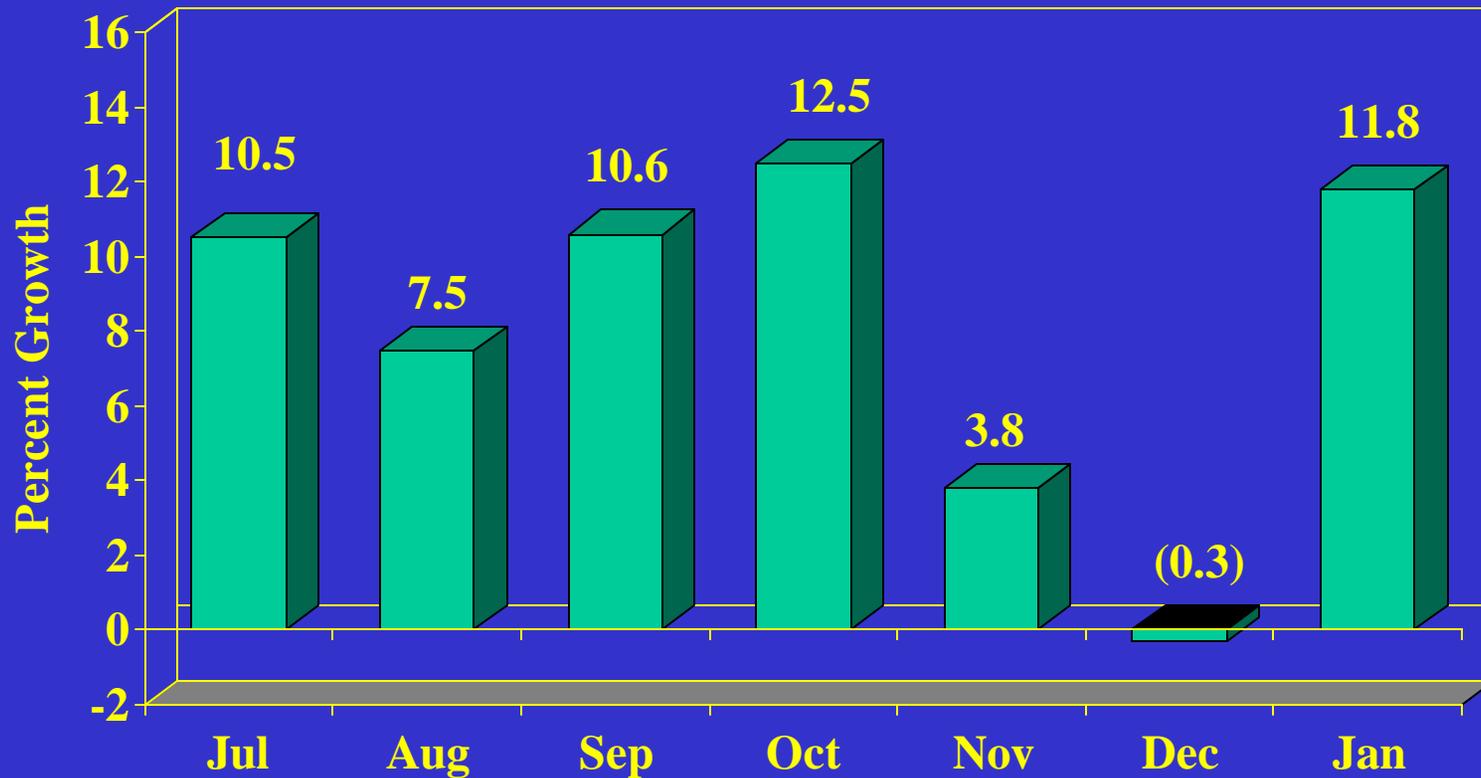
Individual Income Baseline: Forecast Stable Growth



Individual Income Tax

- Over the past 3 months, average monthly withholding tax growth has slowed to 5.1%, compared to average growth of 10.2% for the first 4 months of FY 2001.
- Estimated payments are up only 2.8% for the fiscal year to date. Poor stock market performance has made the outlook for capital gains related revenues uncertain.
- Personal Income Taxes have followed strengths in employment and capital markets in recent years. What is the chance of significantly slower growth?

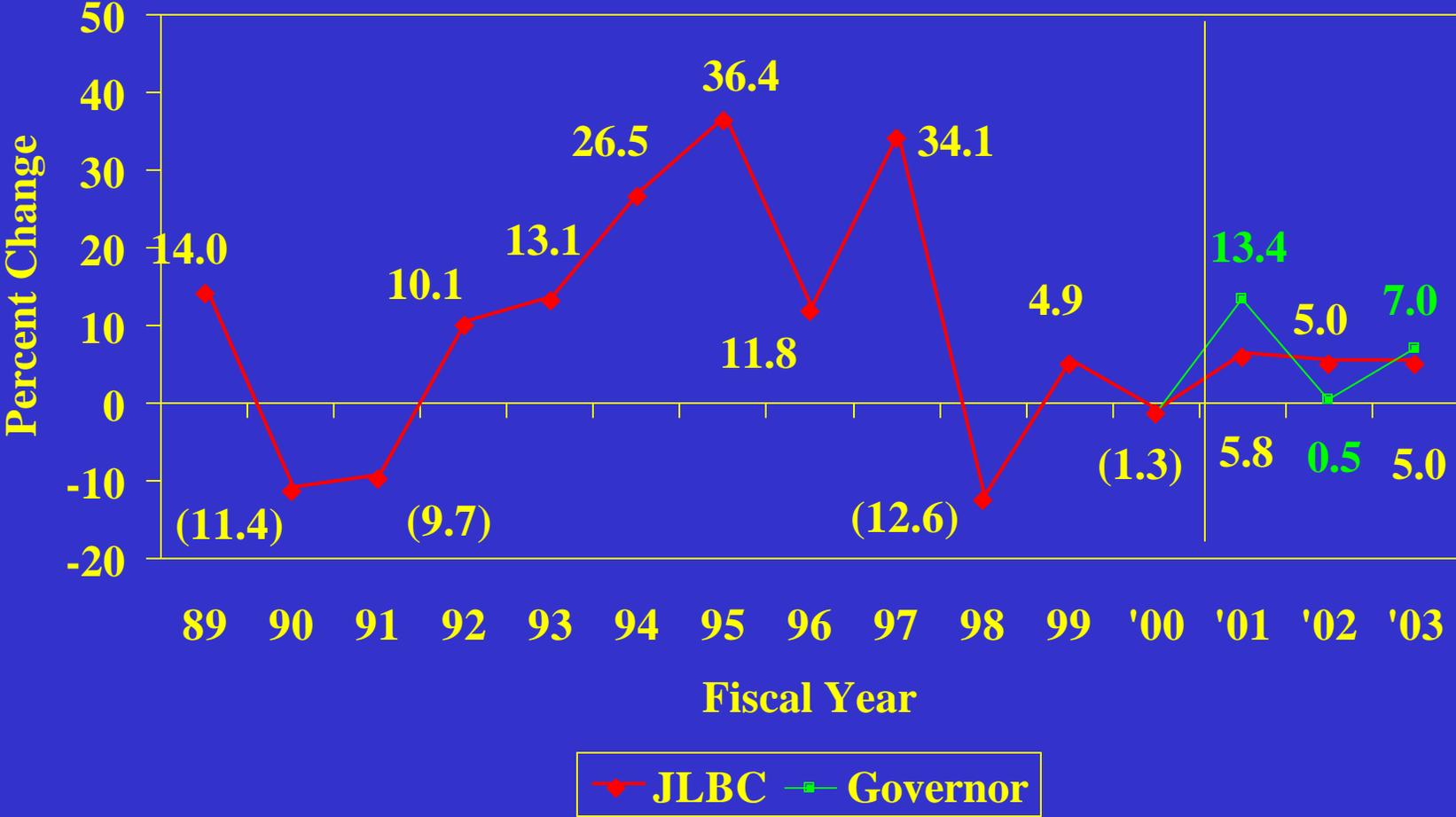
Monthly Withholding Growth



YTD: 7.8% Annual Forecast: 9.0%

*** Over same month in prior year**

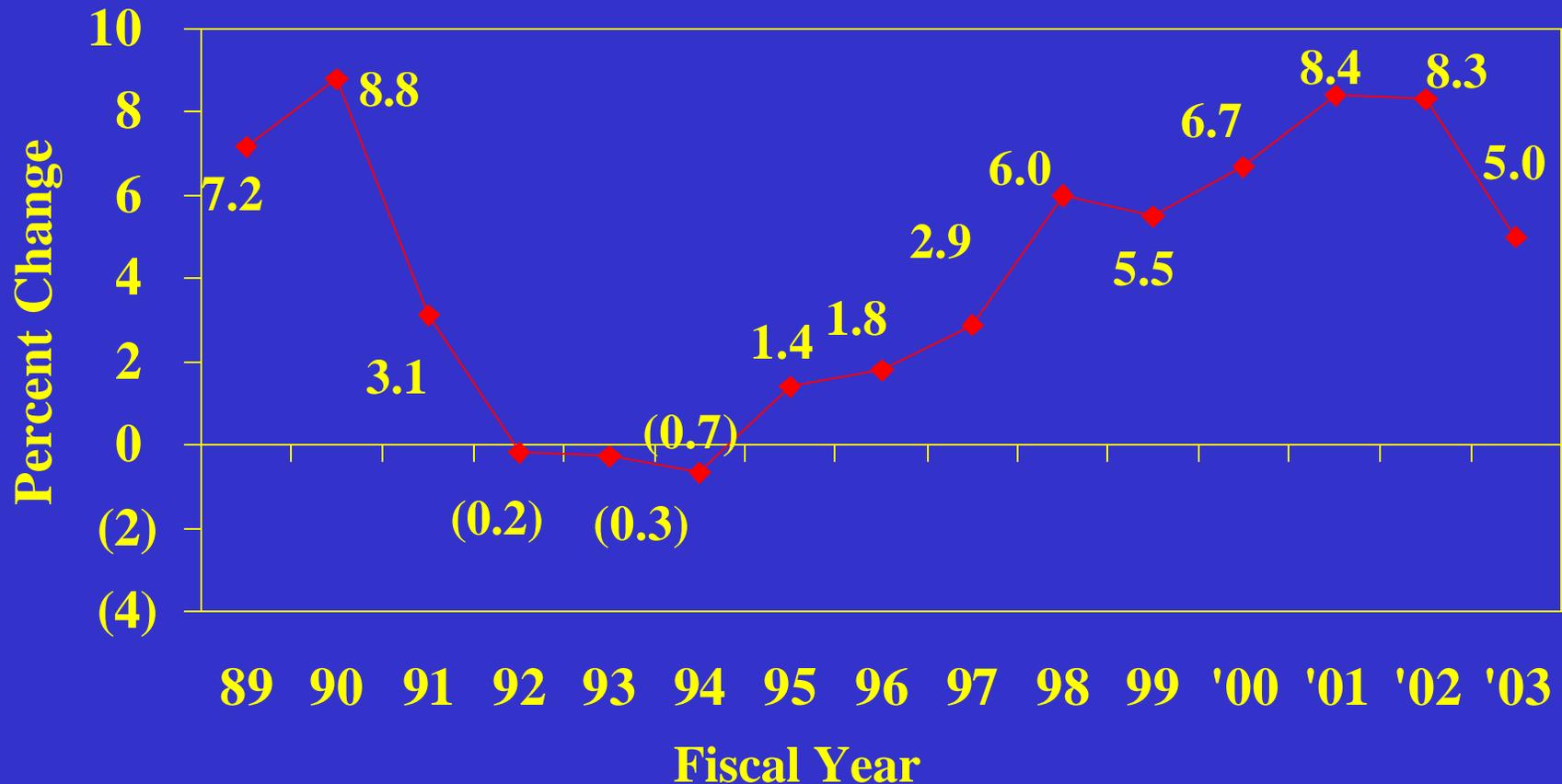
Corporate Income Tax Baseline: Most Volatile Revenue Source



Corporate Income Tax Collections Have Been Very Strong

- Net collections through January are well ahead of forecast, with an excess of \$42.9 million.
- Original cost estimate of \$10 million for lifting the R&D tax credit cap may be understated. New legal opinion, however, could limit impact.
- Will weak collections in April and June overshadow the strong collections so far?

Property Value Growth: Remains Strong



* Represents Net Assessed Value, including SRP property.

Outlook for Net Assessed Value Remains Good

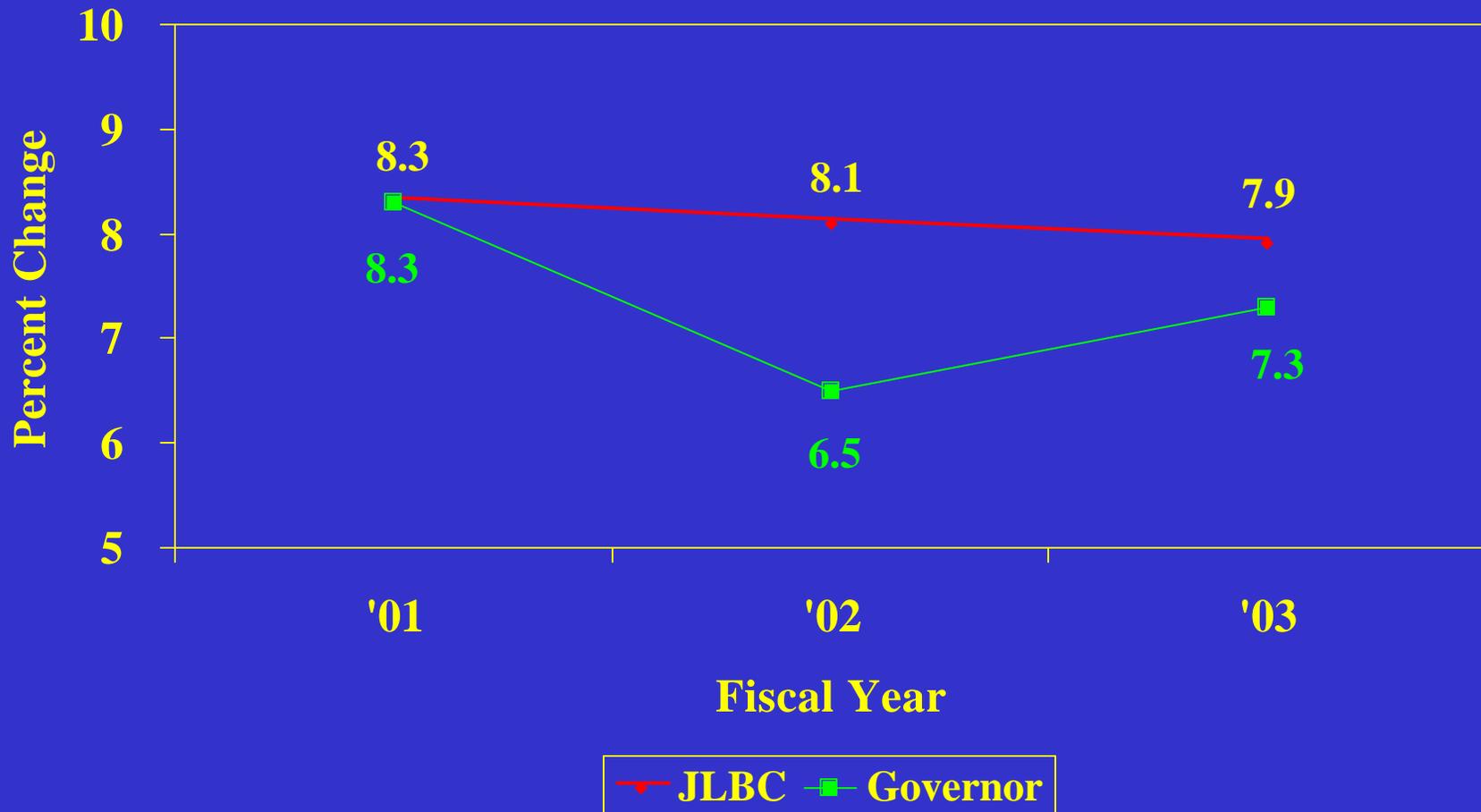
- Net Assessed Value (NAV) will grow by 8.4% in FY 2001 – the highest growth rate in the current business cycle. Preliminary FY 2002 growth is 8.3%.
- Existing property is showing surprising growth – expected to appreciate by 3.0% in FY 2002 compared to 1.8% in FY 2001.
- Existing property growth affects truth in taxation rates. K-12 qualifying tax rates expected to fall 6 to 13 cents.

Historical Baseline Revenue Growth

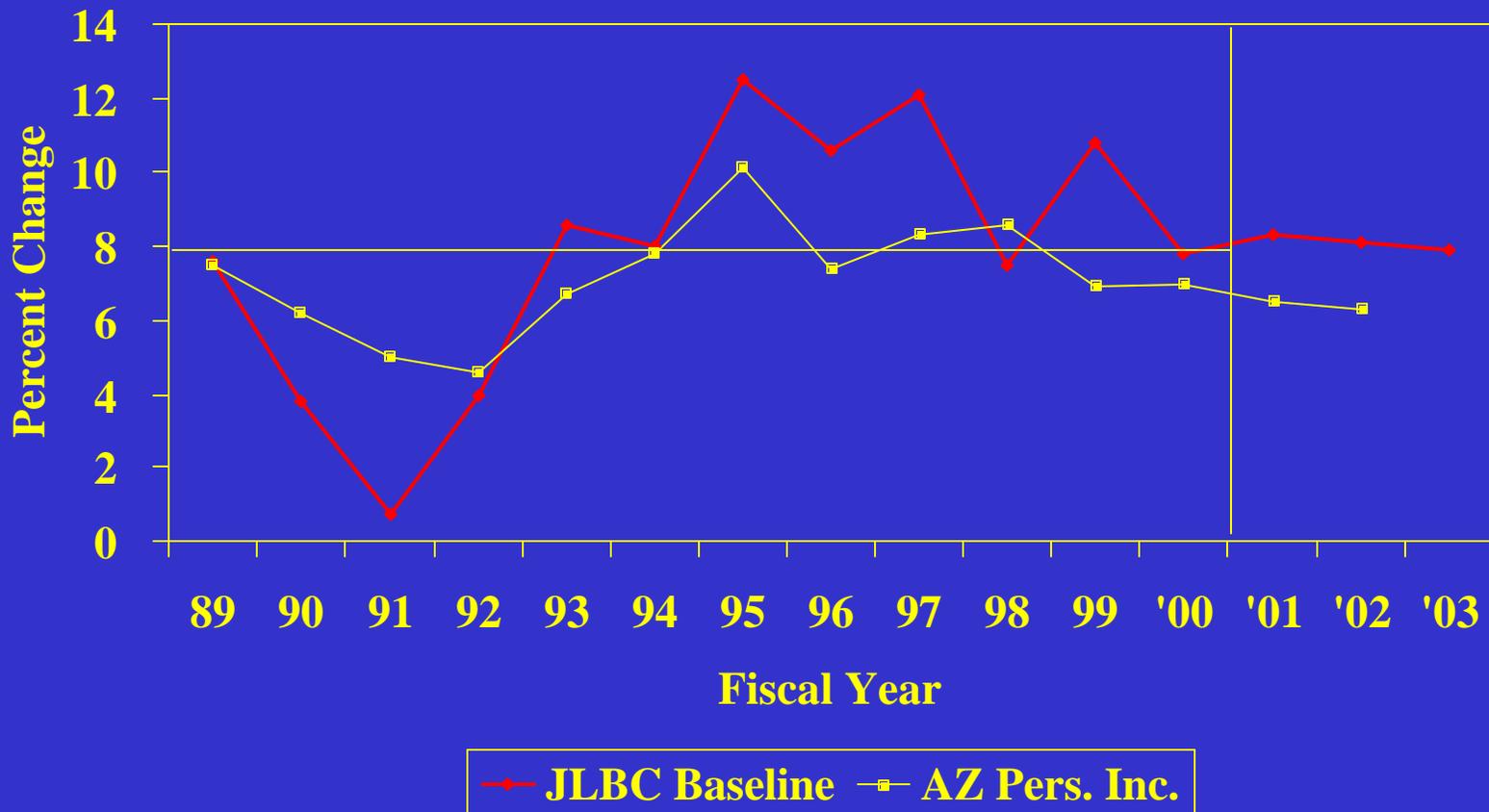
7.8% Last 12 Years – 9.8% Last 5 Years



Baseline Revenue Growth Forecast Period



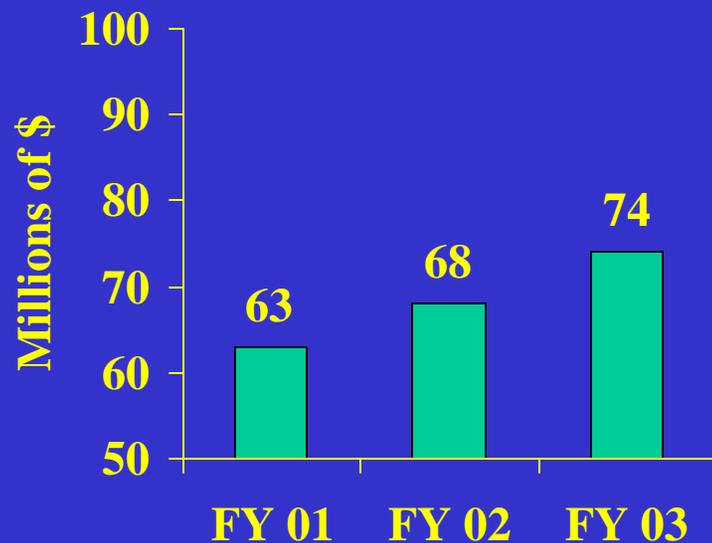
Total Baseline Revenues Roughly Correlated with AZ Personal Income



FY 2001 - 2002 PI = AZ Blue Chip

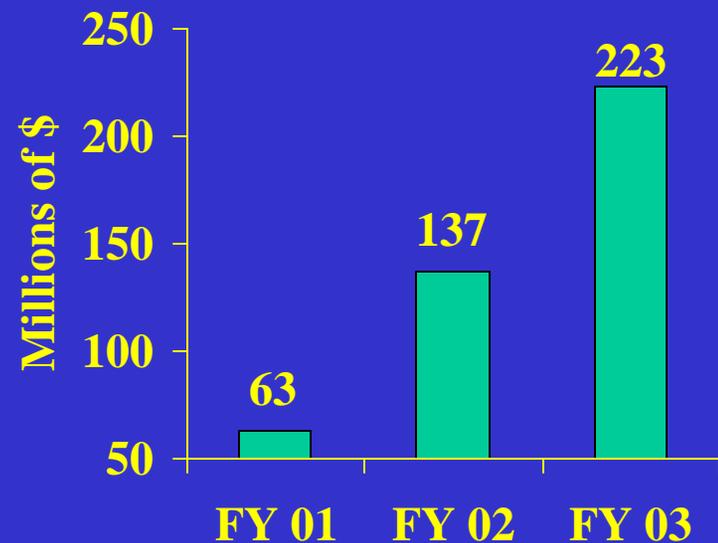
Small Shifts in Revenue Growth Over 3 Years Have Significant Impact

**1% Change in FY 01
Only**



Total Impact = \$205 M

**1% Change in FY 01-
FY 03**



Total Impact = \$423 M

Questions to Consider

- 1) Will we make the FY 2001 forecast?
- 2) Will the Arizona economy quickly return to normal rates of growth?

Goodbye

and

Good Luck,

Kent!

ARIZONA
REVENUE HIGHLIGHTS
JANUARY 2001

January revenues finished \$(16.9) million below forecast for the month. For the year-to-date, revenues are \$36.3 million above the original budget forecast. The January JLBC budget recommendation assumes that FY 2001 revenues will finish \$100.7 million above the original forecast, so the state needs to exceed the original forecast by another \$64.4 million over the rest of FY 2001 to meet the revised forecast. The final January revenue figures are a bit lower than was estimated in our preliminary report issued earlier in the month.

Nearly every tax category came in below the original forecast this month. The sales tax finished \$(4.3) million below forecast, the individual income tax was \$(9.5) million below projections, and the corporate income tax missed the forecast by \$(6.7) million.

Sales Tax revenues in January grew by 4.1% over the previous January, causing the year-to-date growth in this revenue category to drop to 6.9%. January sales tax data includes consumer spending that occurred in the Christmas season, making sales tax figures in this month an important indicator of consumer spending trends. The relatively weak growth of 4.1% suggests that Arizona consumers spent less freely this holiday season. By contrast, sales tax collection growth was 11.5% in January of 2000. A brief description of collections in the major sales tax categories follows:

- **Retail Sales Tax** revenues increased by 3.2% this month and are now 6.4% ahead of last year. The January growth rate of 3.2% is barely more than the rate of inflation, which means that there was scant economic growth last month.
- **Contracting Tax** collections fell by (3.1)% from the previous January, bringing the year-to-date growth in this category to 3.0%. Perhaps the recent interest rate decreases will stimulate activity in the construction industry.
- **Use Tax** revenues continued to surge, growing by 17.6% in January and by 16.8% year-to-date. The use tax is levied on items purchased by Arizona residents in other states and brought back to this state for use.

Individual Income Tax collections through January are \$(24.9) million, or (1.6)%, below our year-to-date forecast. The monthly forecast error was \$(9.5) million and is mostly attributable to lower-than-expected collections of estimated payments. Estimated payments, which are typically associated with incomes other than salaries, including capital gains and other non-traditional forms of employee compensation, are only 2.8% above last year's collections.

Although estimated payments, as a proportion of total income tax receipts, are considerably lower than withholding revenues in dollar terms, this category has been the chief contributor to the much larger-than-expected income tax collections in the last few years. Unless the recent trend of slower growth in collections of estimated payments is reversed, it may prove difficult to meet our individual income tax forecast.

Corporate Income Tax collections in January were weak, falling \$(6.7) million below forecast. While gross collections met expectations, refunds were larger than anticipated, exceeding the forecast by \$8.0 million. Year-to-date collections still exceed the forecast by \$42.9 million, or 15.6%.

JLBC

Collections in January historically represent less than 5% of the year-end totals, and do not provide much insight into where collections may fall for the remainder

of the fiscal year. We will need to wait until April before we can speculate about the remainder of the year.

FY 2001 GENERAL FUND REVENUE COLLECTIONS DIFFERENCE FROM PRIOR YEAR AND THE FORECAST (\$ in Millions)										
	Current Month					Fiscal Year-to-Date (Seven Months)				
	Actual	Difference From		Difference From		Actual	Difference From		Difference From	
	January 2001	Last Year	%	Forecast	%	Through	Last Year	%	Forecast	%
TAX REVENUE	<u>January 2001</u>	<u>Amount</u>	<u>%</u>	<u>\$</u>	<u>%</u>	<u>January 2001</u>	<u>Amount</u>	<u>%</u>	<u>\$</u>	<u>%</u>
Sales and Use	\$281.2	\$11.2	4.1%	\$(4.3)	(1.5)%	\$1,746.2	\$112.4	6.9%	\$8.5	0.5%
Income-Individual	323.5	16.2	5.3	(9.5)	(2.9)	1,580.0	103.7	7.0	(24.9)	(1.6)
-Corporate	9.7	(12.3)	(55.9)	(6.7)	(40.8)	318.2	54.9	20.8	42.9	15.6
Property	0.4	0.0	15.4	0.1	19.6	21.8	(0.8)	(3.6)	(0.0)	(0.1)
Other Taxes	12.7	(2.8)	(18.1)	(1.7)	(12.1)	135.7	(13.8)	(18.1)	2.5	(12.1)
Urban Rev. Sharing	<u>(33.0)</u>	<u>(1.6)</u>	5.0	<u>0.0</u>	0.0	<u>(231.3)</u>	<u>(10.9)</u>	5.0	<u>0.0</u>	0.0
Sub-Total Taxes	594.4	10.8	1.9	(22.1)	(3.6)	3,570.6	245.4	7.4	29.1	0.8
OTHER REVENUE										
Lottery	1.7	0.1	4.6	(0.2)	(8.8)	11.3	2.3	25.8	1.2	11.9
Interest	7.8	1.5	24.8	2.1	36.8	44.1	10.3	30.5	15.3	53.3
Other Miscellaneous	<u>13.5</u>	<u>2.8</u>	25.6	<u>3.3</u>	32.1	<u>51.8</u>	<u>(28.7)</u>	25.6	<u>(9.3)</u>	32.1
Sub-Total Other	23.0	4.4	23.6	5.2	29.4	107.3	(16.1)	0.0	7.3	7.3
TOTAL REVENUE	\$617.4	\$15.2	2.5%	\$(16.9)	(2.7)%	\$3,677.9	\$229.3	6.7%	\$36.3	1.0%

* * *

SELECT ECONOMIC INDICATORS

<u>Indicator</u>	<u>Time Period</u>	<u>Current Value</u>	<u>Change Over Prior Year Period</u>
Arizona Leading Economic Indicators	October	110.3	1.4%
Arizona Unemployment Rate	December	3.7%	(0.3)%
Arizona Jobs	December	2.32 million	3.7%
Arizona Building Permits	October	\$971.5 million	16.0%
Arizona Population	July	5.13 million	2.5%
Arizona Personal Income	3rd Quarter	\$131.0 billion	7.7%
U.S. Real GDP	4th Quarter	\$9.40 trillion	1.4%
U.S. CPI Index	4th Quarter	174.2	2.8%

FINANCE ADVISORY COMMITTEE

November 20, 2000

Highlights

- *The consensus of the FAC is that the national and state economies will continue growing through the foreseeable future but at a slower rate.*
- *The economic landscape has become cloudier in recent months, suggesting growth may moderate in the short-term, but the basic underlying dynamics of the economy remain strong and portend expansion over the long run.*
- *Consumer spending has been the engine that powers this economy and panelists are unsure how much longer it can continue at this rate in the face of higher interest rates and high consumer debt.*
- *The FY 2001-03 revenue forecast will encompass a 30-month time horizon. With such a long forecast period, small percentage errors in the forecast can compound into large dollar impacts. A 1% error in the projected growth rate each year between now and FY 2003 will change the level of available revenues in the next biennium by \$423 million.*

It's that time of year again. The weather is turning cold, the shopping is heating up, and state government is preparing another biennial budget. As the JLBC Staff prepares its spending and revenue projections for the upcoming FY 2002-03 budget, the Staff sought the counsel of its Finance Advisory Committee (FAC) on November 20th. The FAC is a 16-member panel of the state's leading economists that meets several times a year to provide timely advice on the state's economic and revenue forecasts. Committee members view the economy as having weakened somewhat, but they stressed that growth is expected to continue, albeit at a lower rate.

Staff Presentation

The first presentation was given by the JLBC Staff on state revenues. (A copy of this presentation is attached and is also available on our web site.) The Staff explained that the state's long-term average baseline revenue growth is 7.8%, and then asked for the committee's opinion on revenue growth over the next biennium. Each of the Staff economists described a few of the salient points related to the forecasts of the major tax categories.

- Brian Schmitz commented on the remarkably high growth of sales tax revenues in recent years. Over the last several years, the sales tax has confounded the experts, growing by 3% more than most economists have projected. The trend has continued through the first 4 months of FY 2001, as the sales tax is already \$18.7 million above forecast. Much of the sales tax growth this year has occurred in categories other than retail sales, such as the utility tax and the use tax.
- Kent Ennis described the uncertainties revolving around the individual income tax. So far this year collections are ahead of last year by 10.9%, but income tax refunds are still a wild card and it is unknown how the sluggish stock market will affect capital gains tax payments. Ennis also explained that the majority of Arizona's income taxes are paid by just 6% of tax filers, illustrating how dependent income tax receipts are on high income filers.
- Jim Rounds called attention to the volatility of the corporate income tax. Over the past 12 years, corporate income tax growth rates have ranged from a high of 36.4% to a low of (12.6)%. In the first quarter of FY 2001, collections are a surprising 38.0% above last year and \$62.3 million above forecast. It is difficult to predict if this excess revenue will remain at the end of the fiscal year, but the Department of Revenue has informed the Staff that significant tax refunds are forthcoming in November and December. Preliminary numbers show that refunds may exceed the forecast for these two months by \$30 million.
- Hans Olofsson told the panel that property value growth remains strong. Net assessed value (NAV) of property is expected to grow by 8.4% in FY 2001 and by 7.0% in FY 2002, which would make these two years the best growth years in the current business cycle. Growth in property values reduces the state share of education costs by \$6 million for every 1% increase in NAV.
- Richard Stavneak summarized the revenue picture, pointing out that over the last 12 years baseline

revenues have grown by an average of 7.8% per year. The Staff revenue forecast for the FY 2002-03 biennium will encompass a 30-month time horizon, making any projection very uncertain.

Explaining that even a small percentage error in the forecast can have a large dollar impact, Stavneak illustrated how a 1% forecast error in FY 2001 alone could change the revenue forecast by \$205 million by the end of the next biennium. In addition, a 1% error each year during the forecast period of FY 2001-03 could result in a \$423 million change in the revenue forecast by the end of FY 2003. Due to the uncertainty of a 30-month forecast, policy makers often elect to use a conservative revenue projection. Finally, he briefly covered the estimated impacts of the ballot propositions that passed in the recent election.

National Outlook

Elliott D. Pollack, of Elliott D. Pollack & Company, presented the outlook for the national economy. The current economic expansion is the longest in U.S. recorded history at 115 months, and Pollack expects it to continue for the foreseeable future. While his forecast calls for continued growth, he projects that growth rates will trend downward in 2001 due to a few clouds on the horizon which make the economy more susceptible to shocks. These include worrisome levels of consumer debt, a wide trade gap between imports and exports, and high oil prices which could cause demand for SUV's and light trucks to dry up. Moreover, the stock market remains mired in a bit of a slump. At the same time, there are factors that suggest the good times will continue to roll, including high consumer confidence levels, a low unemployment rate, lofty productivity levels, and favorable demographic conditions. The net result of all this is, in Pollack's view, slower growth but no recession, moderate consumer spending, and continued high productivity.

State Outlook

Tracy Clark, of Arizona State University, gave the next presentation on the state of the Arizona economy. He acknowledged the difficulty state economists have had with forecasting the sales tax, as the Blue Chip consensus forecast for retail sales has consistently been lower than actual collections. Clark explained that retail sales have been driven by purchases of big-ticket items such as cars and furniture, and sales of both of these items have flourished of late. The state's employment growth continues to be excellent, although, interestingly enough, most of the growth is occurring outside of Maricopa County. In general, Clark expects continued but slower growth in the near future. He characterized his projections as being a

little less optimistic than when the FAC last met in August.

The final presentation was given by Brian Cary, of Pinnacle West Capital Corporation. He remarked on the extraordinary growth of U.S. GDP (gross domestic product) over the past 4 years. GDP has grown by 2.5% or more every quarter in this period, which is amazing when you consider that conventional wisdom once held that the economy could not sustain growth of over 2.5% for very long. Cary also highlighted the high volume of car sales. While he does not expect car sales to continue at this pace, the market shows no signs of abating. He projects that consumer confidence will slip in 2001, due in part to the weakening stock market. Cary speculated that baseline revenue growth over the next biennium would be a little below the long-term average in FY 2002 but return to the average by the end of FY 2003.

Other Issues

Dan Anderson, of the Department of Economic Security, informed the panel that a lot of stock options were paid out by one large employer in the first and second quarters of this year. This could portend a surge in final payments of the individual income tax in April when taxes are due. If this occurs, it would be an unexpected boost to income tax receipts.

Attendance at this meeting of the FAC numbered 28 people, including the State Treasurer and 5 current and just-elected state legislators.