

STATE OF ARIZONA

**Joint Legislative Budget Committee**

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STEPHEN TULLY

**FINANCE ADVISORY COMMITTEE**

**March 1, 2006**

**Senate Hearing Room 1 – 12:00 p.m.**

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Members Present:

Dan Anderson, Arizona Board of Regents  
Jay Butler, Arizona State University  
Tracy Clark, Arizona State University  
John Lucking, ECON-LINC  
Georganna Meyer, DOR  
Elliott Pollack, Elliott D. Pollack and Co.  
Randie Stein, Stone & Youngberg LLC  
Blaine Vance, Treasurer's Office  
Don Wehbey, DES

Mr. Richard Stavneak, Director, JLBC Staff, welcomed everyone to the Finance Advisory Committee (FAC) meeting.

Mr. Tim Everill, JLBC Staff, provided a slide presentation and handout with an overview of state revenues and issues for the panel to consider. ([Click here to view handout](#))

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

Mr. Tracy Clark gave a presentation using a handout on the Arizona economy. ([Click here to view handout](#)).

Mr. Stavneak asked Mr. Pollack's perspective on the growth path that the JLBC Staff laid out based on the consensus forecast.

Mr. Pollack said he felt it was conservative for this year and next year. He expressed caution that a lot of this revenue is transitory. The housing market traditionally turns over 7-1/2% to 8% every year. Last year 12% of the housing market turned over, so there are huge capital gains that will not repeat. If \$100 billion of the money people nationwide are currently taking out of their house goes away, that will be a huge hit to Arizona sales tax revenue. Mr. Pollack noted that as good as things are this year and next year, if you spend it all, you are going to dislike the results in 2009 and 2010.

Mr. Clark urged caution in terms of making huge permanent increases in what we commit spend downstream, or assuming most of the money can be given away. Most of this money is not going to be here in a couple of years.

Mr. Stavneak asked what could be the worst scenario and its cause in the next 18 months.

Mr. Pollack said the unknown could be a horrific terrorist event that could affect the whole economy. Another possible, but unlikely scenario, would be if the Chinese get tired of buying our Treasury Bills.

Mr. Clark agreed that a terrorist event would affect the economy.

Mr. Stavneak asked if the volatile situation of real estate prices could significantly hurt us in the next 18 months despite the rapid run up in the last year.

Mr. Pollack said the Arizona Multiple Listing Service shows that housing prices jumped between mid-2004 and mid-2005, but have been flat since last June. If housing prices decline, it could have some impact. Even if they decline, however, a large percentage of the gains are not going to be given back, so it should not be an issue. The issue will be whether people can continue to refinance their home and take money out.

Mr. Clark said that housing price appreciation at the federal level is fairly modest. At the state level, Arizona was first in the nation with a 34.9% increase in the housing price index in 2005 compared to 1980, when Arizona ranked 19<sup>th</sup> in the nation. There has been a huge increase in a short period of time, but it still has not put us at the highest point overall compared to the ongoing price appreciation that some other places in the United States have seen.

Mr. Pollack said that if you look at the distribution of housing prices, housing is still affordable for most people.

Mr. Stavneak noted that even with the possibility of housing permits declining this year, there is enough momentum in the economy, and the construction industry in particular, that you just don't turn that off.

Mr. Pollack replied that there are 130,000 more people in Phoenix at the end of each year. A housing unit is needed for every 2.5 people.

Mr. Stavneak asked if there are any concerns about the number of houses for sale.

Mr. Pollack said the number is up to 30,000, which is higher than 2002. What needs to be looked at is the number of days on market. The days on market from 2000 until 2003 was 64 days, then in 2004 it dropped to 5 days, and is now back to 50 days. It will get back to 60 days or above which will put pressure on housing prices. It will not be a disaster, however, it means housing prices will not go up as much as income and housing affordability will look better.

Mr. Stavneak asked the panel to give their perspective of where they think the state is headed in terms of the economy, state General Fund revenues, and the housing market.

Mr. Blaine Vance said they are looking at things on more of a short-term basis. They believe that there may be 2 to 3 more rates hikes from the federal government.

Mr. John Lucking reiterated that the revenue stream will not continue to increase at the current rate. As baby boomers get older, they look to lock in income streams. They tend to switch out of stocks and into bonds, which makes an interesting case for long term interest staying relatively low because of the demand for bonds staying strong. The economy as a whole looks slower in 2006 than 2005, but not

dramatically slower. The risk is that things may be too strong, which may trigger the federal government's reaction, but the risk will not be until 2007 and 2008.

Mr. Stavneak asked for the panel's reaction to the wage data that appears to be growing significantly more than personal income projections.

Mr. Clark said not all of the wage data is incorporated into the personal income, and the numbers will have to be revised upward. It will change people's perception as to what is going to happen in the economy.

Ms. Randie Stein said that, due to the large portion of state revenues that may be one-time in nature, that revenue collections could drop off before the economy in general begins to slow down.

Mr. Stavneak said that one-time expenses do not necessarily mean that something occurs just 1 time, they can occur several times. This concept is occurring right now.

Mr. Hans Olofsson, JLBC Staff, said in response to a question regarding capital gains, that the Congressional Budget Office has a preliminary number of 48% for the capital gains increase for 2004 at the national level. He noted that the number would potentially be higher for the state, in the 50% to 70% range.

Mr. Stavneak added that this increase in capital gains should replicate itself for 2005 and 2006.

Mr. Don Wehby said we have a substantially better economy than what was being reported last year. New figures for January have been released along with the benchmark figures. There are no significant pattern changes, most revisions are for the most recent years. One of the challenges is to work out a way with the federal government to incorporate the revisions backward so we have a longer period or series to look at. The newly released information will also be on the DES website.

Mr. Pollack asked if the magnitudes of the revisions are similar to those from Tracy Clark's presentation.

Mr. Wehby replied that they are similar, with better growth. The last press release reported 110,000 over-the-year jobs added. In the last FAC meeting, it was noted that we were seeing substantial wage increases. It took a couple of quarters to work out the validation on the initial anomalies to the data. In regard to the benchmark figures, it is a better and stronger economy. There is broad based growth throughout most of the industries. There are improvements with the 3<sup>rd</sup> quarter that confirms better growth and better wage growth. He is concerned that even if things stay healthy, even in 2005, there can be tight labor markets. The hurricane damage can start to take scope of what that means in terms of construction activity and investment flows, and it could have an impact on construction labor here. There will be a mix of how many people you can get for the wage. It was something we have experienced in this recovery period, with the inability to find the number of workers to meet demand.

Mr. Stavneak said that part of the dilemma is that a lot of times there is real-time raw economic data and real-time revenue data, but those don't seemingly match. For example, last year, the raw economic data did not seem to match the 19% growth in state General Fund revenues. Now, through the revision process, the revised numbers are not showing a growth in the overall economy at 19%. However, it is catching up so that the raw economic data looks much better than it did at the time it was initially gathered. It is easier to understand why we had the 19% growth in revenues last year once you see the revised data that is now coming in.

Mr. Wehby said that we are seeing substantial 12% to 15% growth in the upper end of wage categories in the state. He noted that there is broad based wage growth, including some in manufacturing, and also in the construction sectors. Earlier preliminary data showed lagging growth in job recovery, with wage recovery growing faster, but revised data is now showing substantial job recovery too.

Mr. Stavneak asked Ms. Georganna Meyer if early in this tax filing season there has been any signs of an abnormal number of returns being processed at this point.

Ms. Meyer replied that it has been a typical year up to this point.

The meeting adjourned at 1:00 p.m.

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Yvette Medina, Secretary

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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**

**March 1, 2006**

**JLBC**

# **FY 2006 Revenue Collections**

## **Strong Year-to-Date Performance**

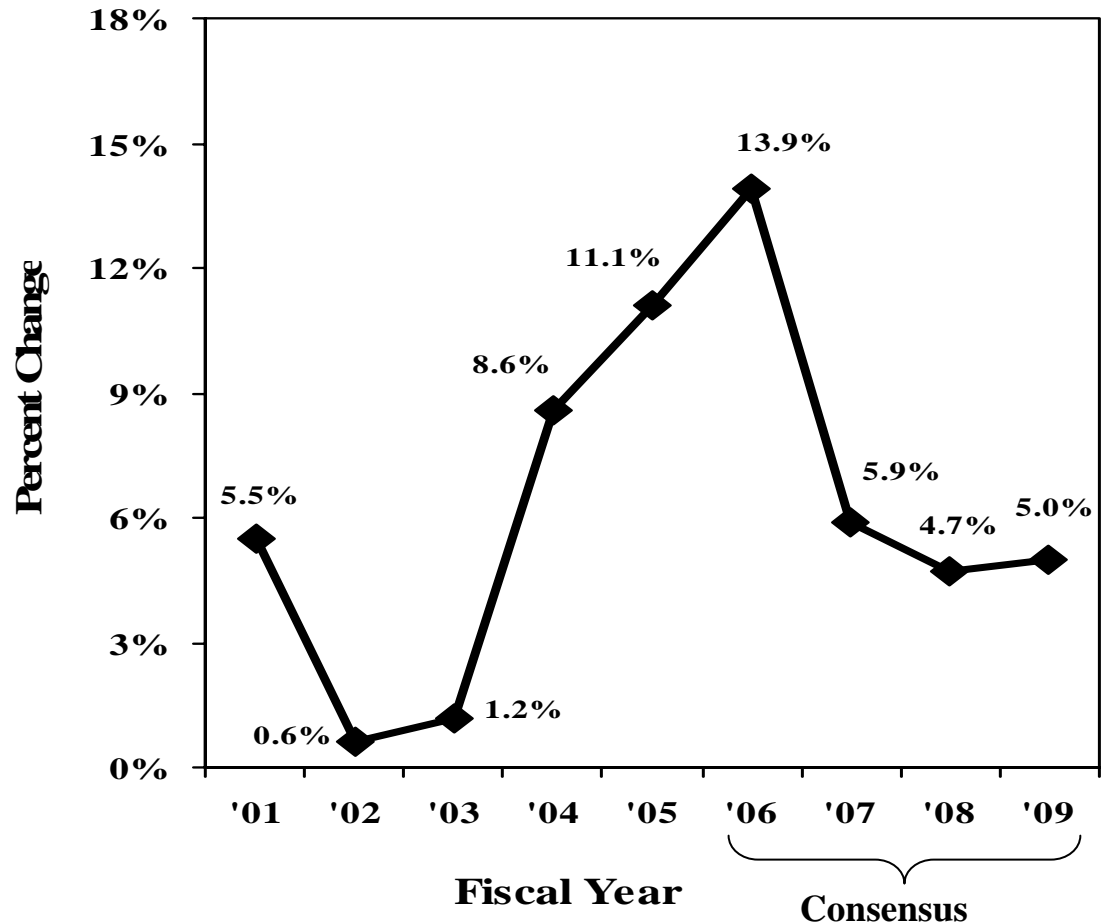
- Since release of January JLBC Baseline, General Fund revenue collections have remained strong.
- January TPT (from December) grew by 18% and January estimated income tax payments grew by 52%.
- January collections are \$91 million above the revised JLBC baseline forecast, released in early January.
- Year-to date base revenue collections are up 19.1% compared to last year.

# Sales Tax Growth Rate

## Consensus Projects 13.9% for FY 2006

- Probably Low as it Only Requires 8.5%  
Growth for Remaining Months

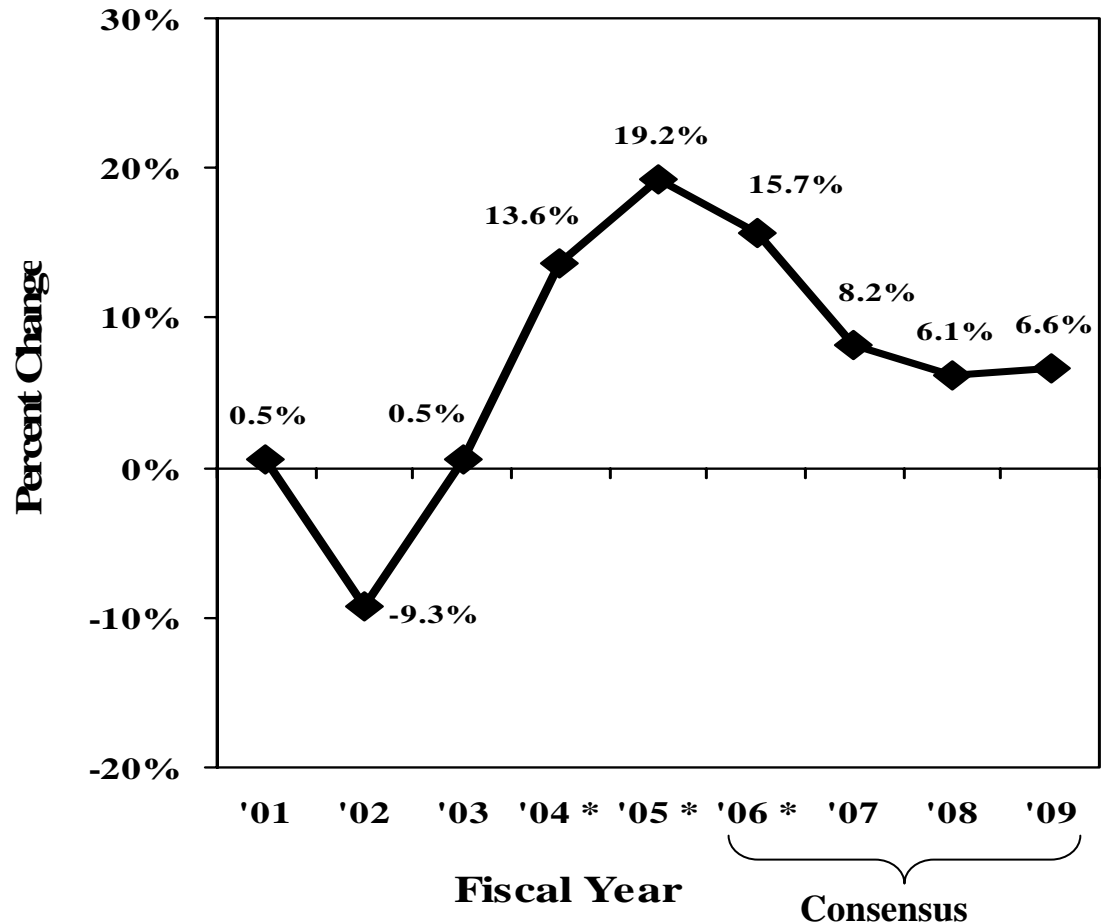
- '06 YTD rate = 17.2%
- '06 JLBC revised = 15.8%
- Consensus projecting slowing growth rates - double-digit growth in '05 actual and '06 estimate primarily due to construction.



# Individual Income Tax Growth Rate

- Assumes 8% Withholding Growth – Has Been 10-12%
- Assumes Refunds Grow More Than Payments in 4<sup>th</sup> Quarter

- '06 YTD rate = 19.2%\*
- '06 JLBC revised = 16.8%

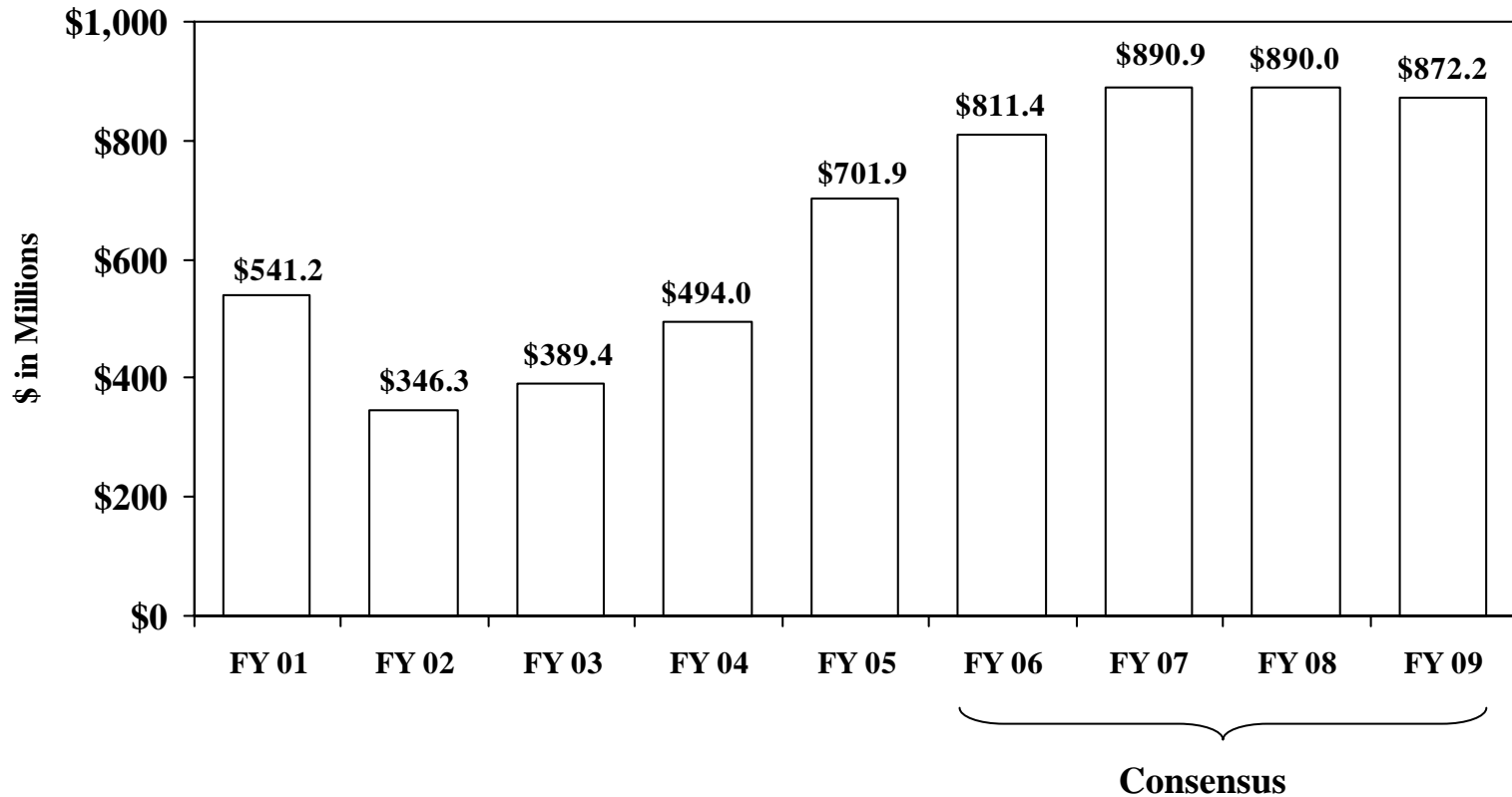


\* FY 04, FY 05, and FY 06 rates adjusted for \$76 M in underwithholding in FY 04 and \$76 M one-time increase in FY 05.



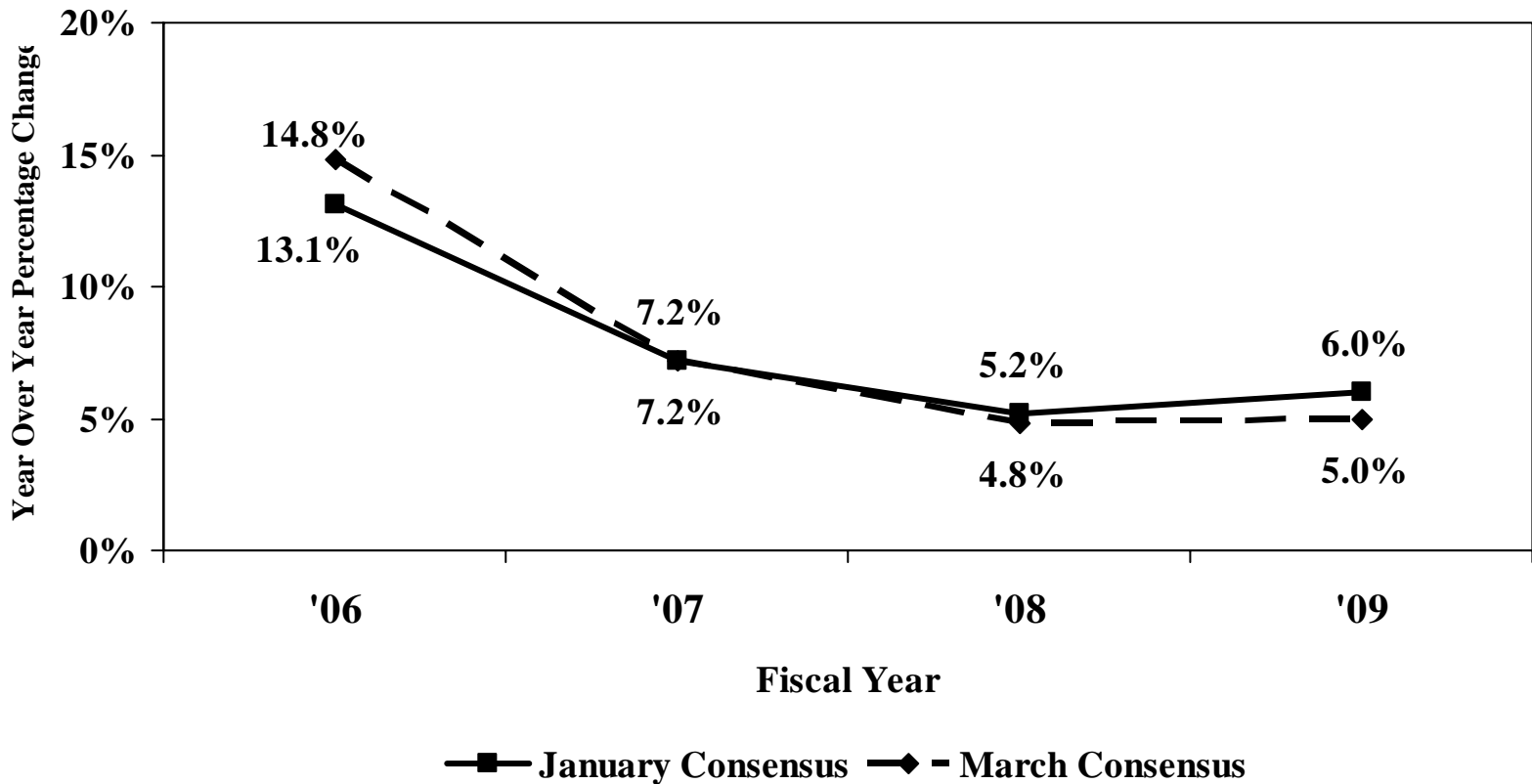
# Corporate Income Tax Collections

- FY 2006 Collections of \$811 M Would  
Require 12.5% Growth for Rest of Year



# **“Big 3” Consensus FY 2007 Forecast Has Remained the Same Since January**

**- FY 2006 Consensus Has Improved Since January, But May Be Low Due to Recent Collections**

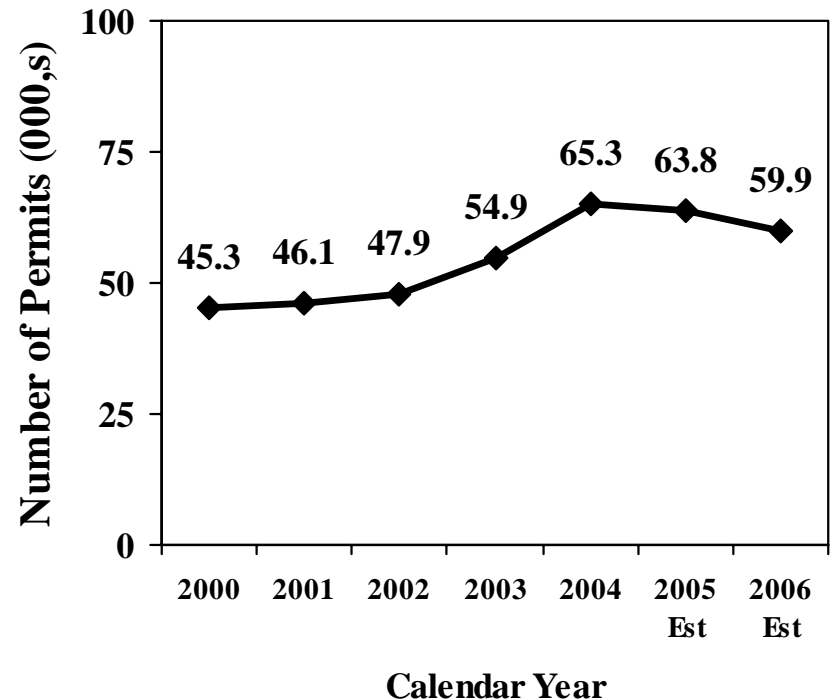


# Risks to the Forecast

- Could Housing Permits Plummet?
- What Would be the Impact?

- While Blue Chip forecasts 60K permits in '06, some analysts have predicted a drop to 35K to 45K.
- What are the chances of a decline of that magnitude?

Greater Phoenix Housing Permits  
(Single and Multi-Family)



## **While Housing is a Threat, the Forecast's Upsides are Greater**

- Potential increases in capital gains could result in increased estimated income tax payments.
- Much more of the rapid housing boom occurred in tax year '05 than '04. This could result in higher final income tax payments in April.
- Increased corporate profits suggest the possibility of increased corporate income tax collections.

# FY 2006 – FY 2009 Quartile Forecast Worksheet

	<u>FY 2006</u>	<u>FY 2007</u>	<u>FY 2008</u>	<u>FY 2009</u>
<b><u>Sales Tax</u></b>				
JLBC Forecast (3/06)	15.8%	6.9%	5.5%	6.0%
UA - Low (1/06 revision)	12.5%	3.1%	1.9%	2.5%
UA - Base (1/06 revision)	12.7%	5.2%	5.1%	5.5%
FAC (3/1/06 Survey)	14.5%	8.3%	6.3%	6.1%
<b>Average:</b>	<b>13.9%</b>	<b>5.9%</b>	<b>4.7%</b>	<b>5.0%</b>
<b><u>Individual Income Tax</u></b>				
JLBC Forecast (3/06)	16.8%	7.5%	7.0%	7.0%
UA - Low (1/06 revision)	14.5%	6.6%	3.8%	4.6%
UA - Base (1/06 revision)	15.0%	9.1%	7.4%	7.9%
FAC (3/1/06 Survey)	16.4%	9.4%	6.0%	6.9%
<b>Average:</b>	<b>15.7%</b>	<b>8.2%</b>	<b>6.1%</b>	<b>6.6%</b>
<b><u>Corporate Income Tax</u></b>				
JLBC Forecast (3/06)	11.2%	5.0%	3.4%	1.8%
UA - Low (1/06 revision)	14.8%	7.9%	-9.9%	-13.7%
UA - Base (1/06 revision)	17.1%	19.9%	4.4%	-1.3%
FAC (3/1/06 Survey)	19.1%	6.3%	1.8%	5.2%
<b>Average:</b>	<b>15.6%</b>	<b>9.8%</b>	<b>-0.1%</b>	<b>-2.0%</b>
<b>Overall Weighted Average:</b>	<b>14.8%</b>	<b>7.2%</b>	<b>4.8%</b>	<b>5.0%</b>

# **National Outlook**

**Prepared for:**  
**Finance Advisory Committee**

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**Elliott D. Pollack & Company**

**March 1<sup>st</sup>, 2006**

# The U.S. Economy



**The economy is currently performing at a high level, and expectations for 2006 are high.**

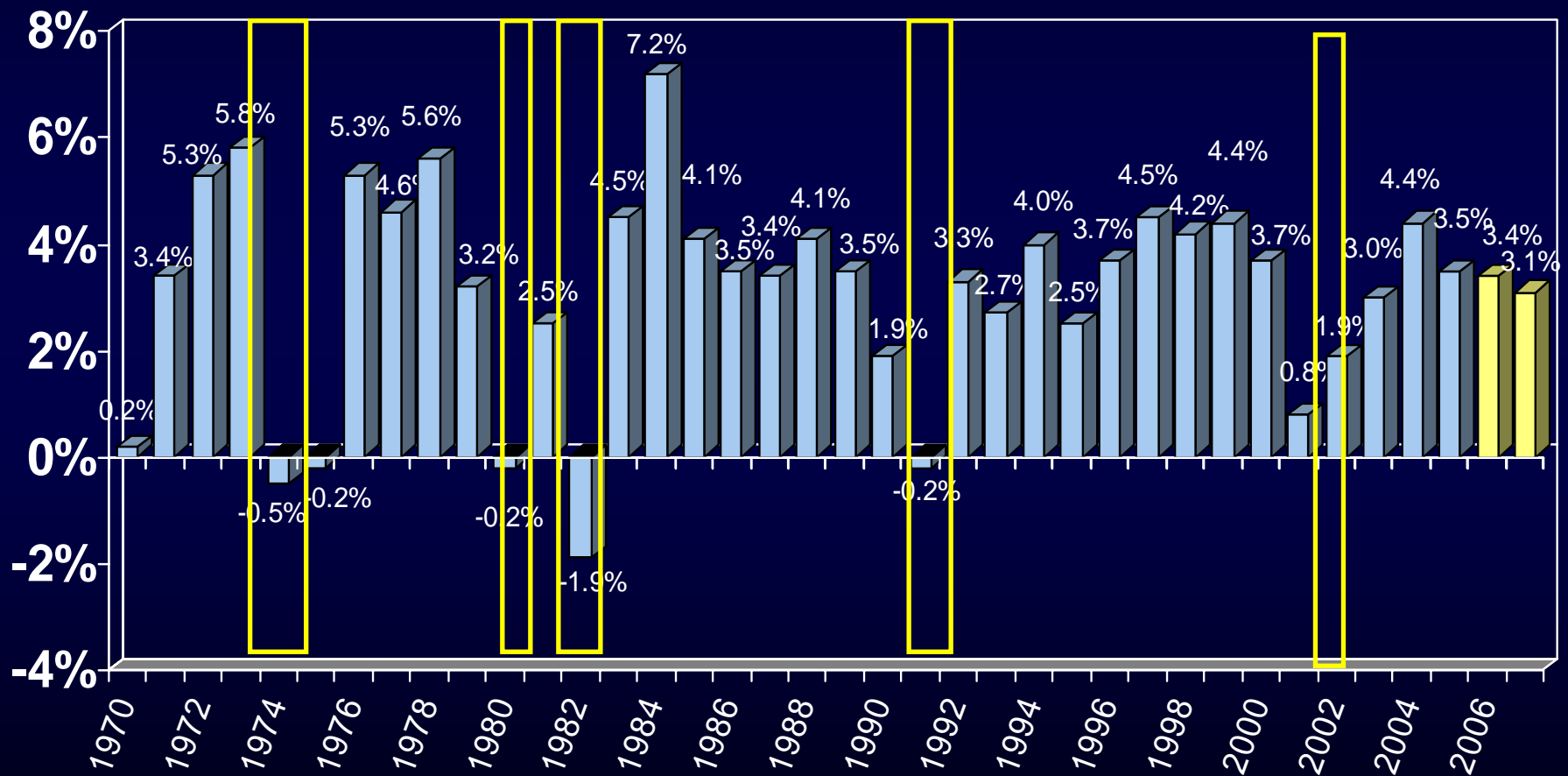
**Since things don't always work out as expected, we need to monitor the data.**



# 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, January 2006

 Recession Periods

# Consumer



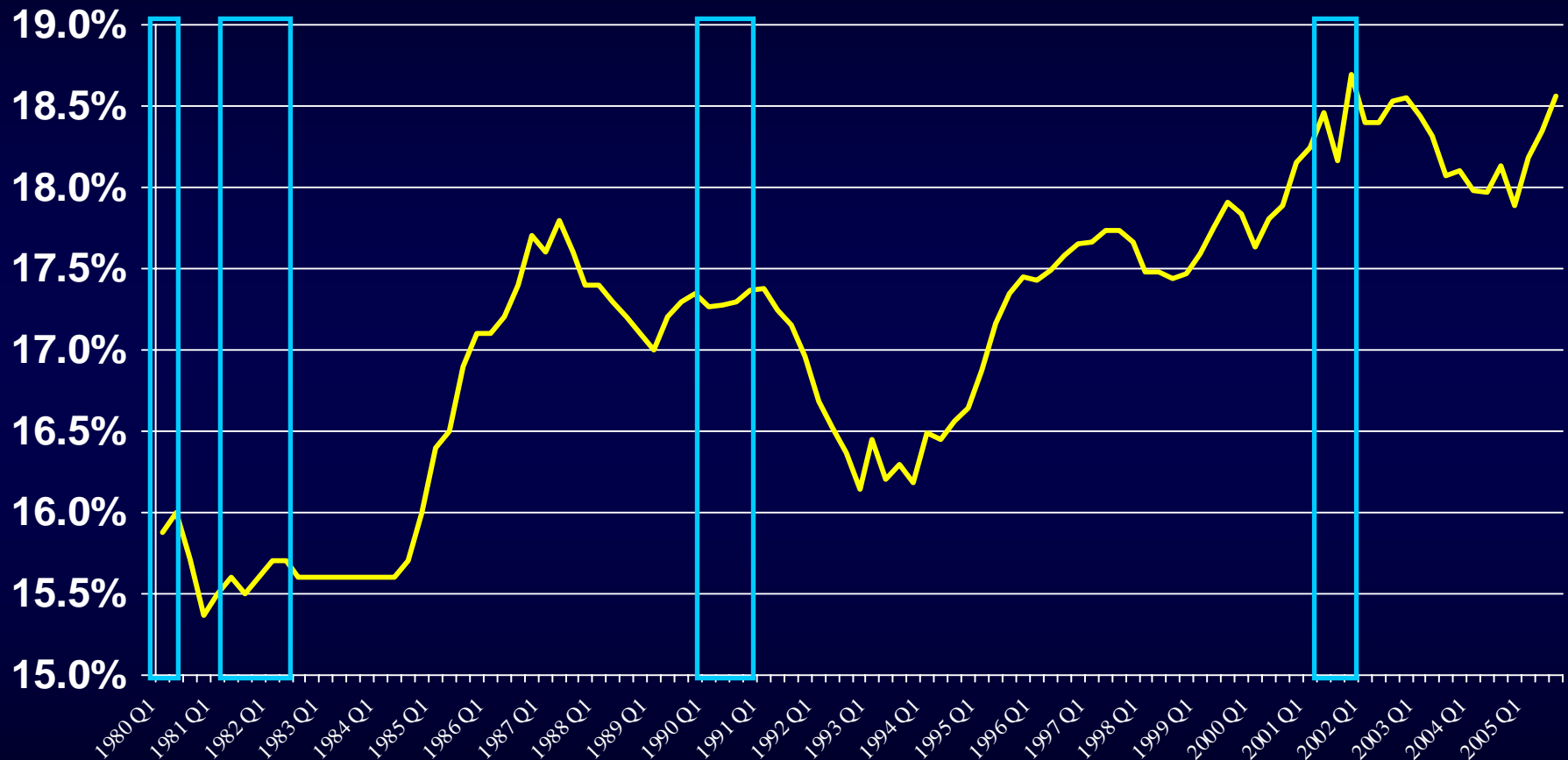
# Why consumers are still spending...

- **Productivity growth → more output growth → more income growth.**
- **Inflation low compared to past four expansions → more real income growth.**
- **Low interest rates → housing demand.**

# Financial Obligation Ratio

## 1980 – 2005\*

Source: Board of Governors, Federal Reserve Board



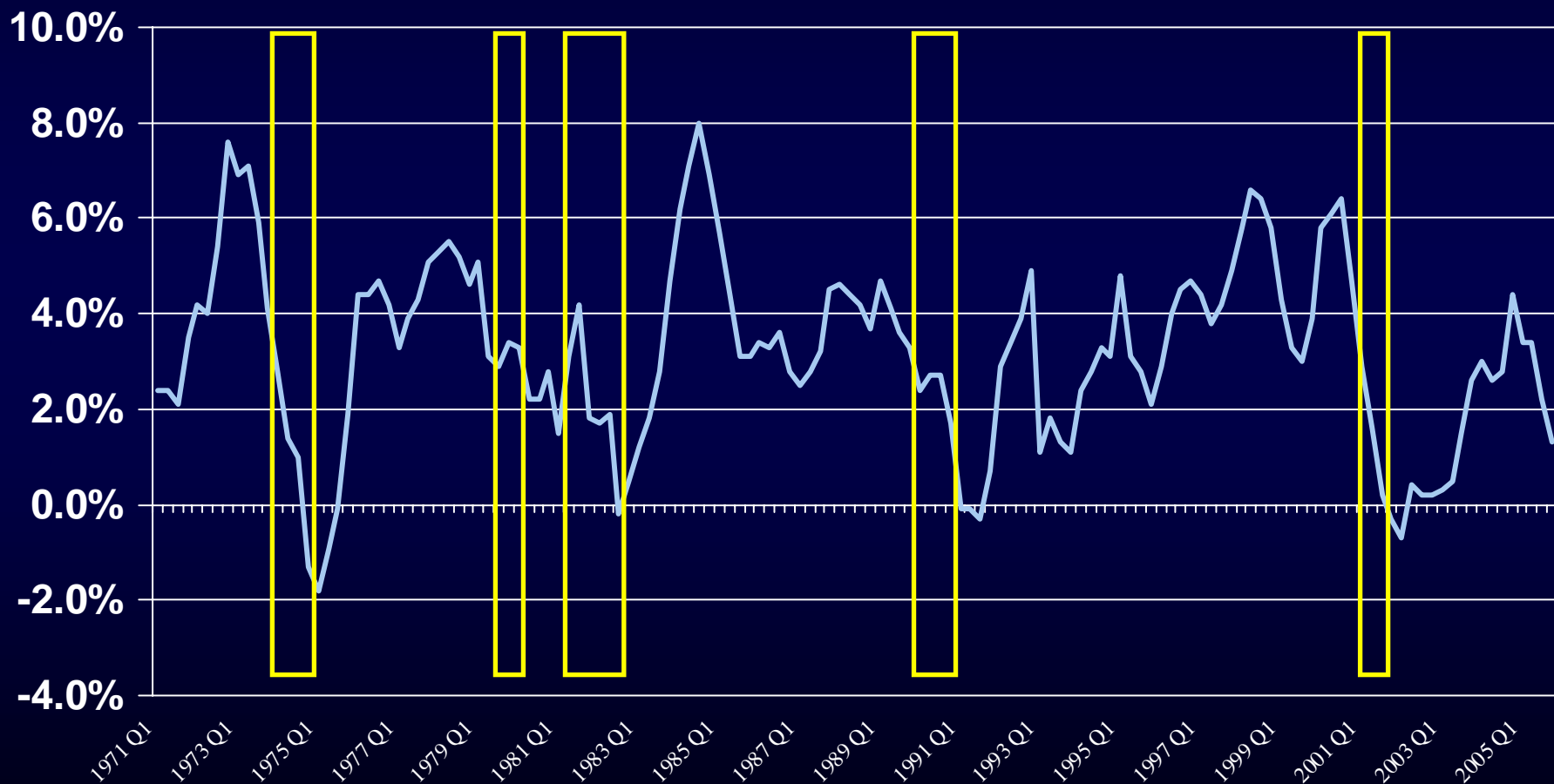
NOTE: The FOR includes debt service payments as a percent of disposable income. The FOR is a broader measure as it includes auto lease payments, rental payments, homeowner's insurance and property taxes.

\*Data through third quarter 2005.

# U.S. Real Personal Income Percent Change Year Ago

1971 – 2005\*

Source: Bureau of Economic Analysis

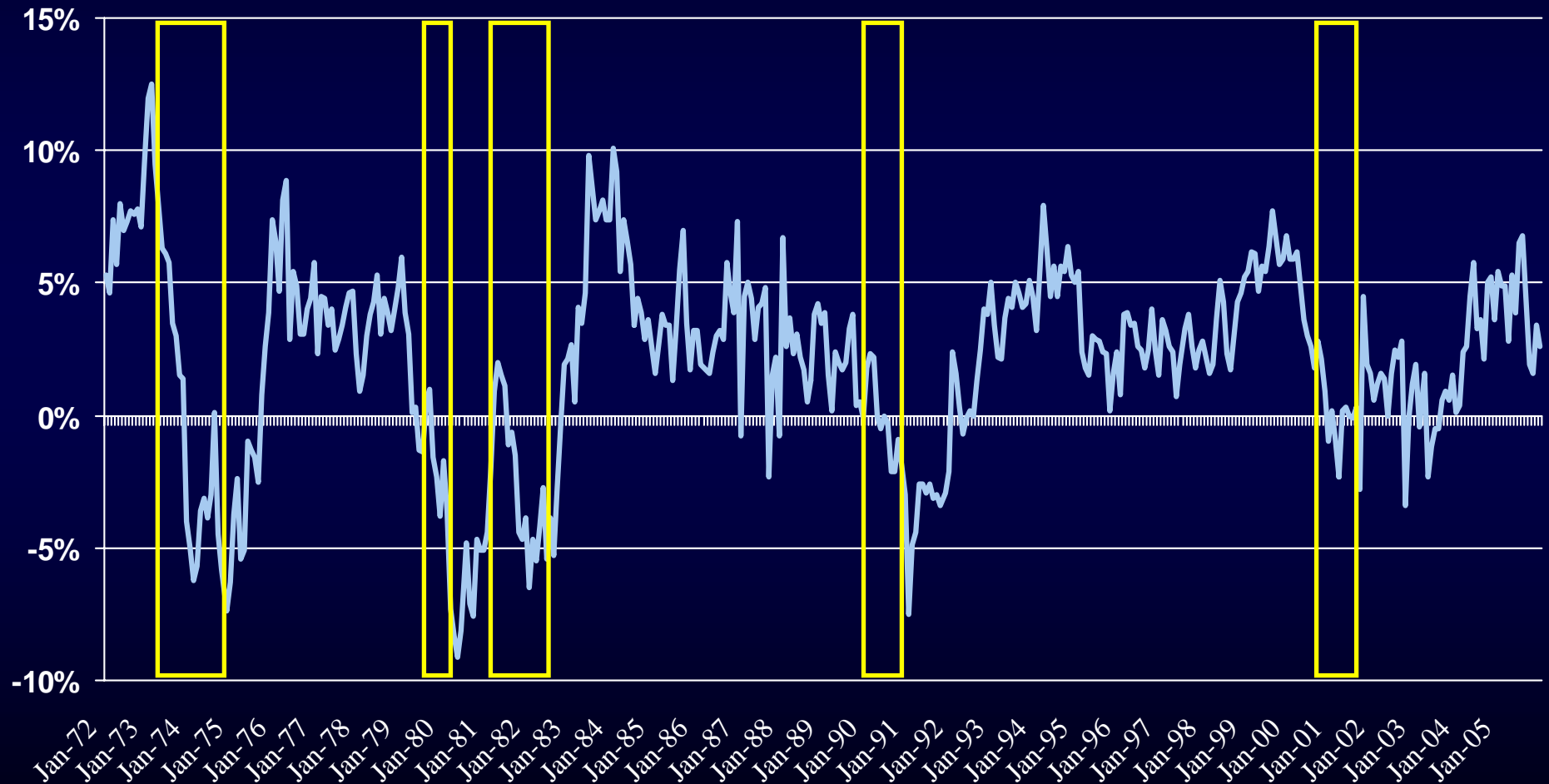


\*Data through fourth quarter 2005

 Recession Periods

# U.S. Real Retail Sales 1972 – 2005\*

Source: Federal Reserve Board of St. Louis

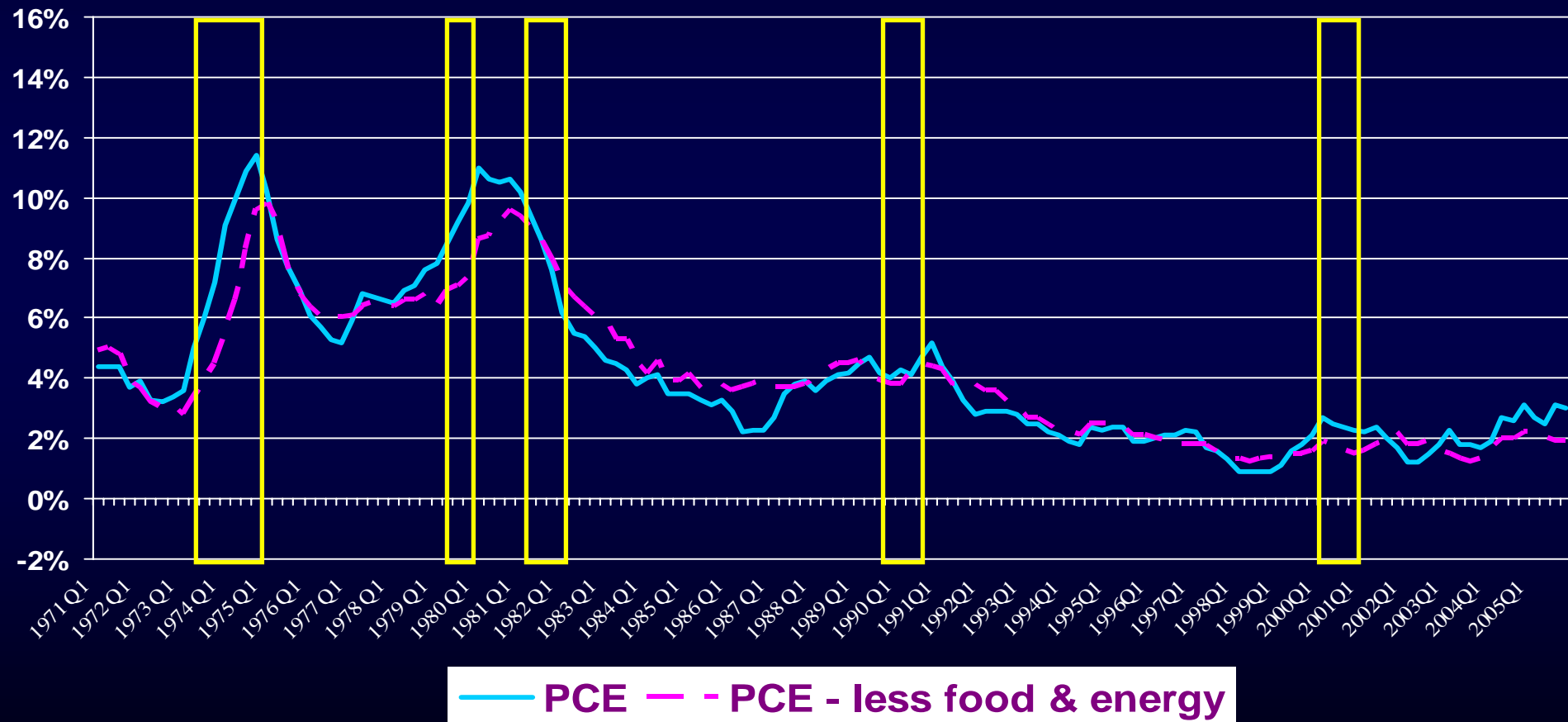


\* Data through December 2005

 Recession Periods

# Personal Consumption Expenditures Price Deflator (2000=100) Percent Change Year Ago 1971 – 2005\*

Source: Bureau of Economic Analysis



•Data through fourth quarter 2005.

Recession Periods

# 30-Year Conventional Mortgage Rates 1982 – 2006\*

Source: Federal Reserve Economic Database

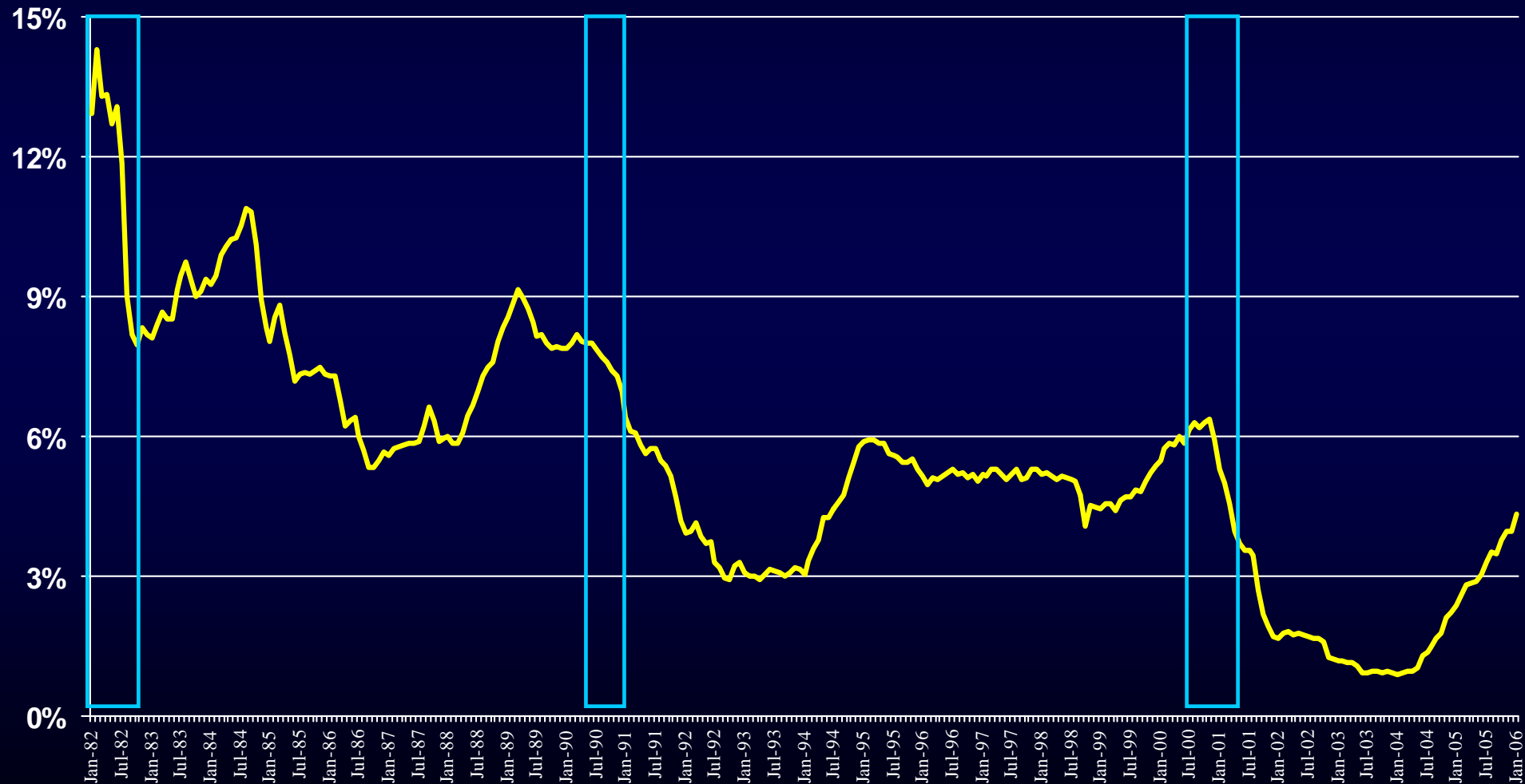


•Data through January 2006.



# 3-Month Treasury 1982 – 2005\*

Source: Federal Reserve Economic Database

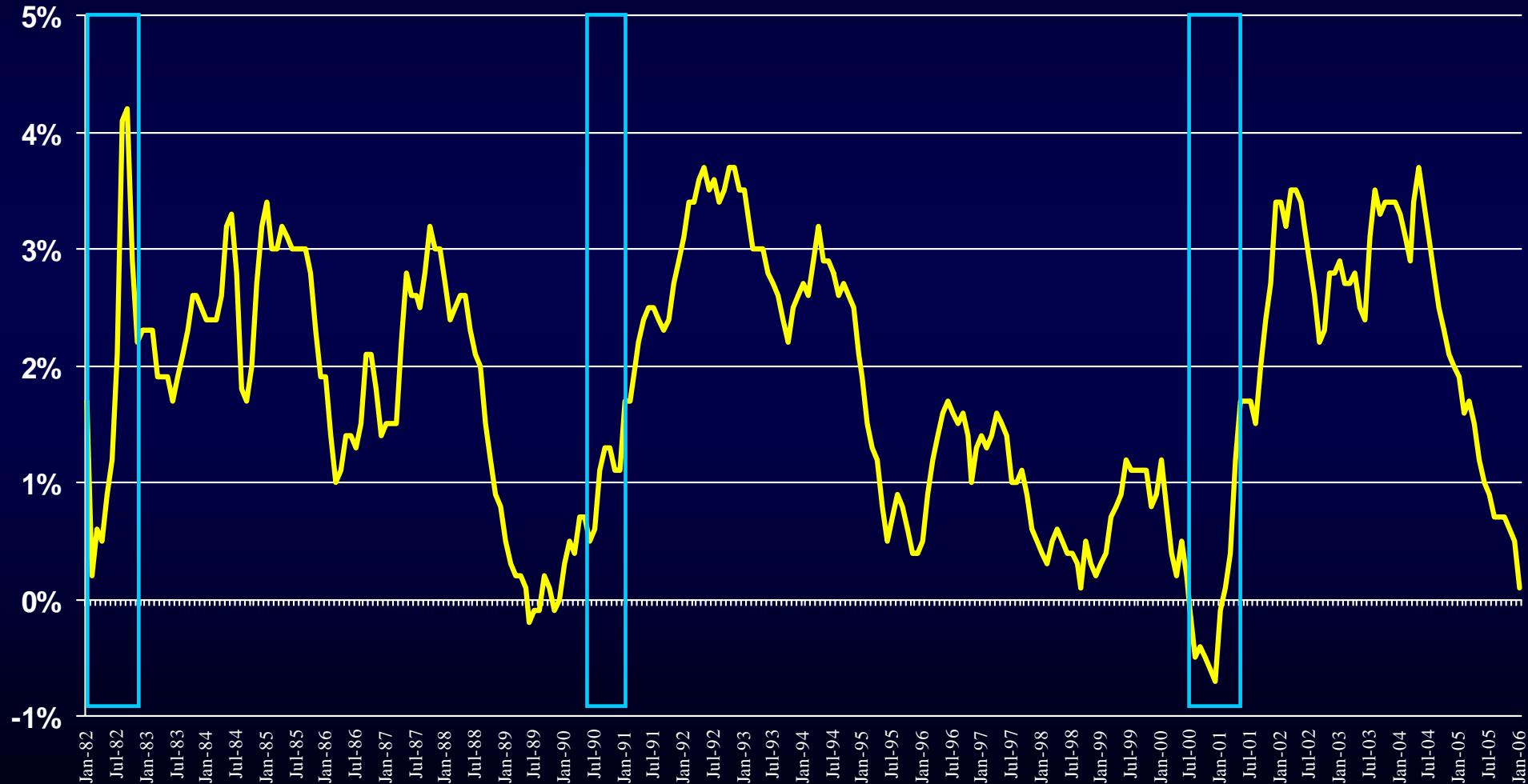


\*Data through January 2006.

# 10-Year Treasury minus the 90-Day T-bill

## 1982 – 2005\*

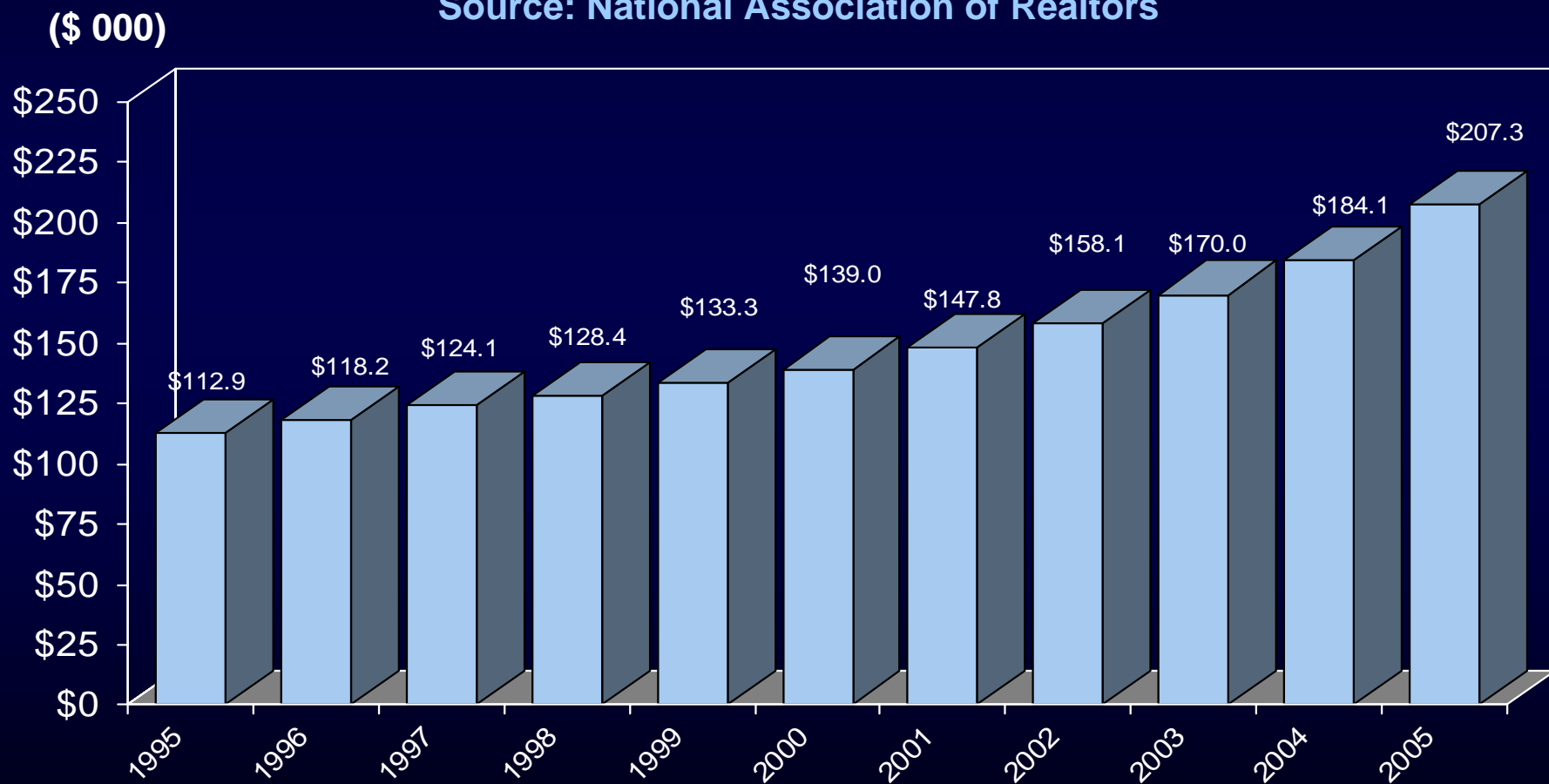
Source: Federal Reserve Economic Database



•Data through January 2006.

# Single Family Median Price of Resales United States 1995–2005

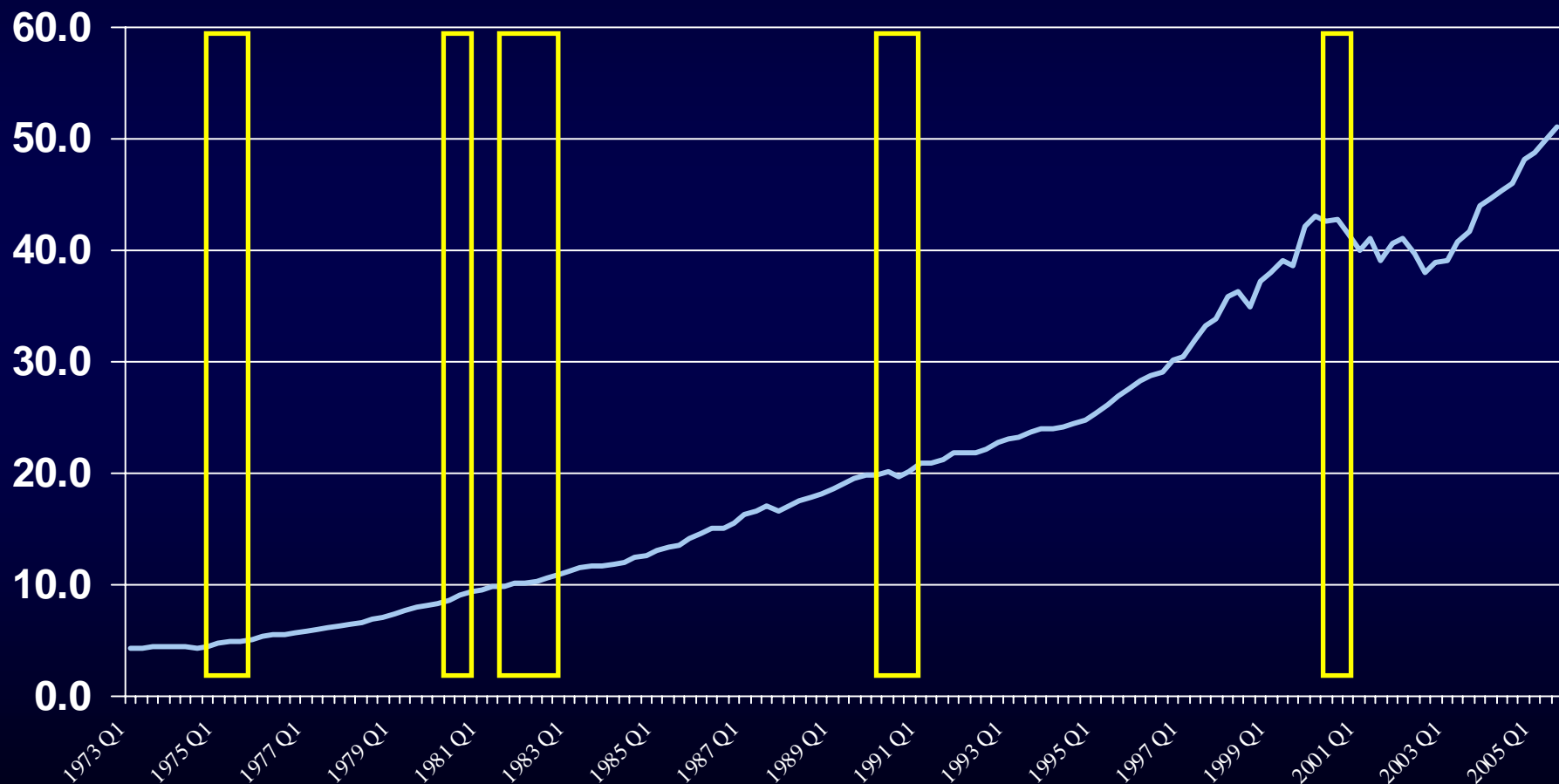
Source: National Association of Realtors



# Household Net Worth

## 1973 – 2005\*

Source: [www.economy.com](http://www.economy.com)



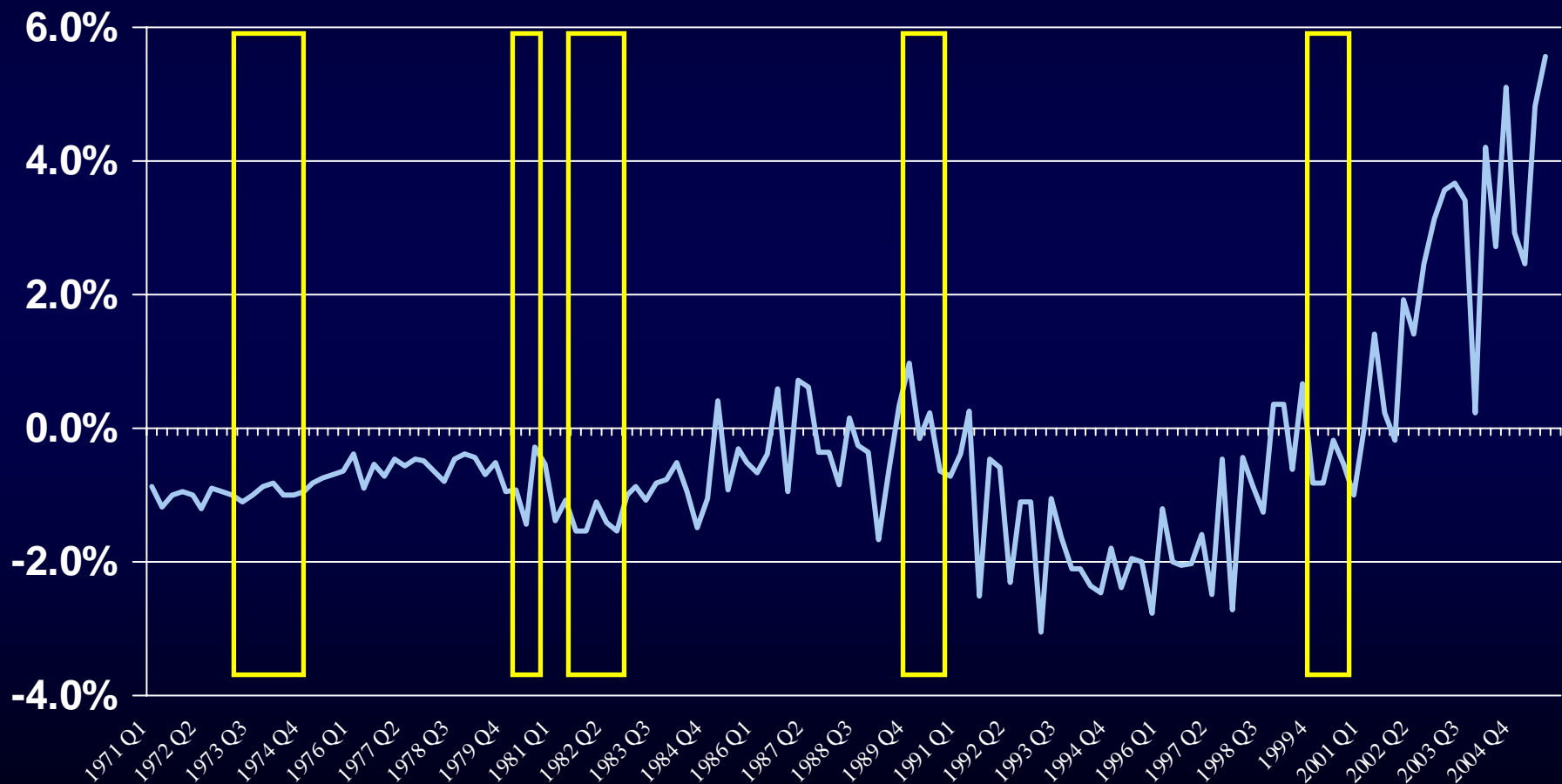
\*Data through third quarter 2005

 Recession Periods

# Mortgage Equity Withdrawal as a share of Disposable Income

## U.S.: 1971 – 2005\*

Source: Bureau of Economic Analysis



\* Data through third quarter 2005

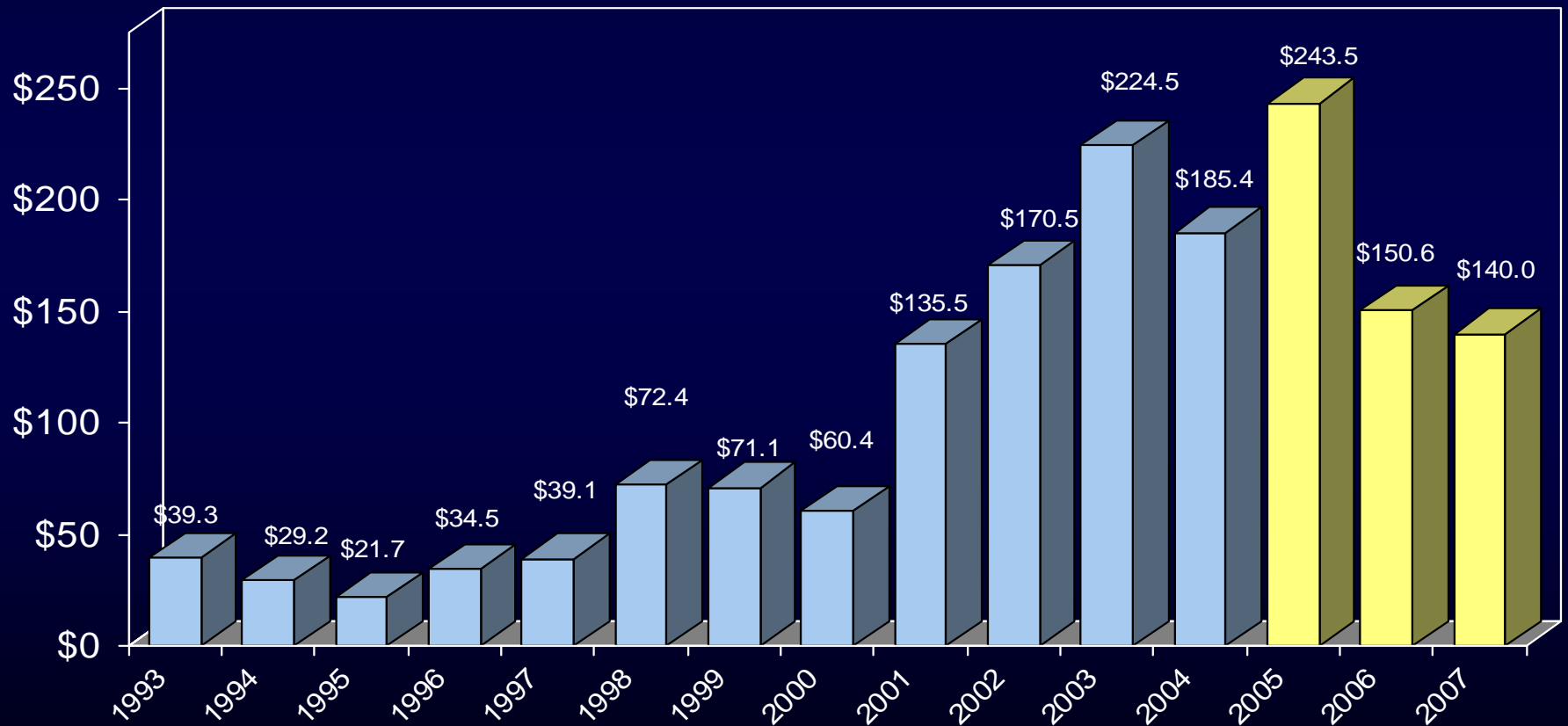
 Recession Periods

# Home Equity Cashed Out

During Mortgage Refinancings, Second Mortgages and Home Equity Credit  
1993–2007\*

Source: Freddie Mac

(\$ Bil)

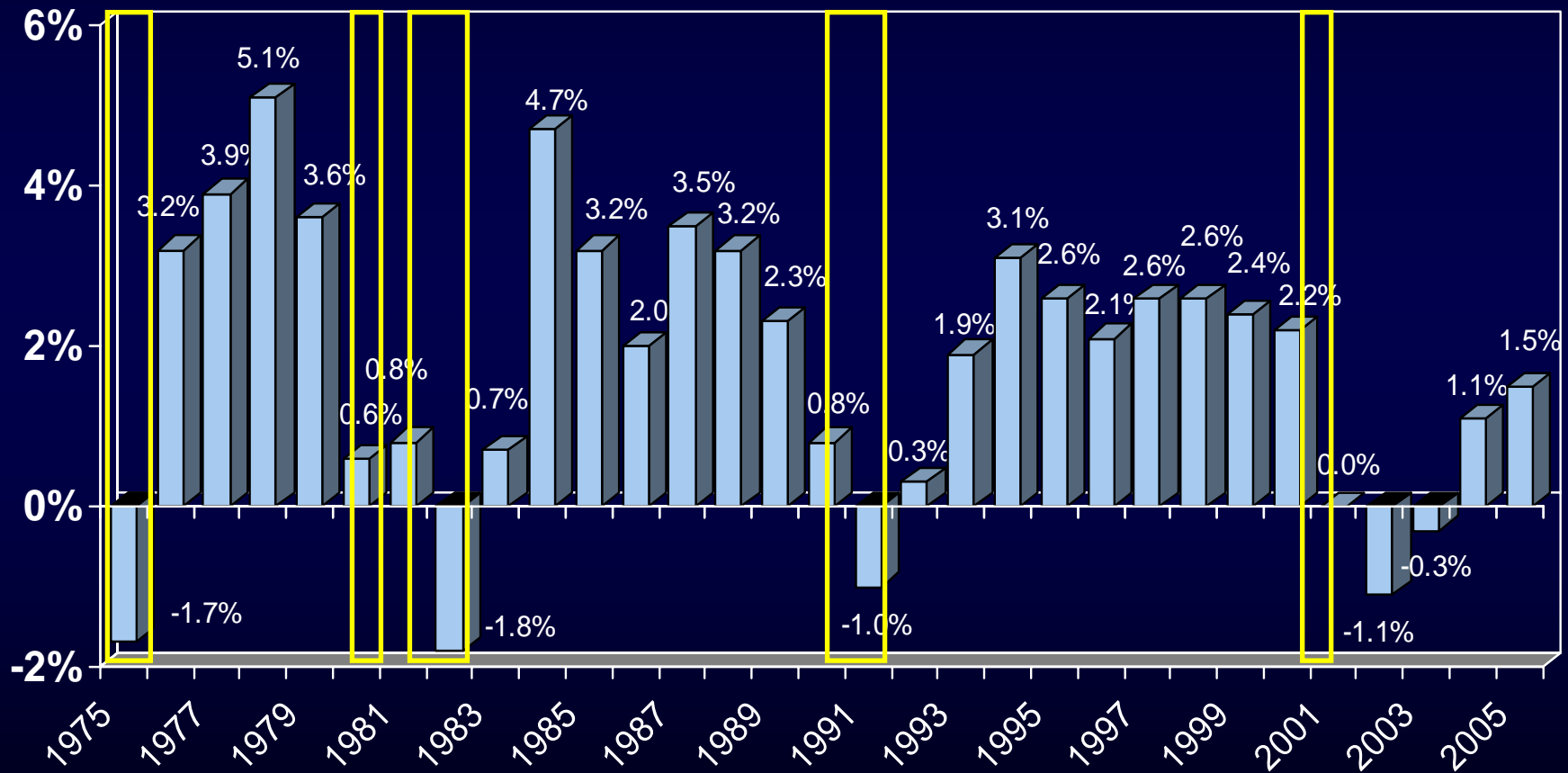


\* 2005 -2007 are forecasts from Freddie Mac.

# National Employment\*

## Annual Percent Change 1975–2005

Source: Bureau of Labor Statistics



\*Non-agricultural wage & salary employment. Changed from SIC to NAICS reporting in 1990.

 **Recession Periods**

# Business

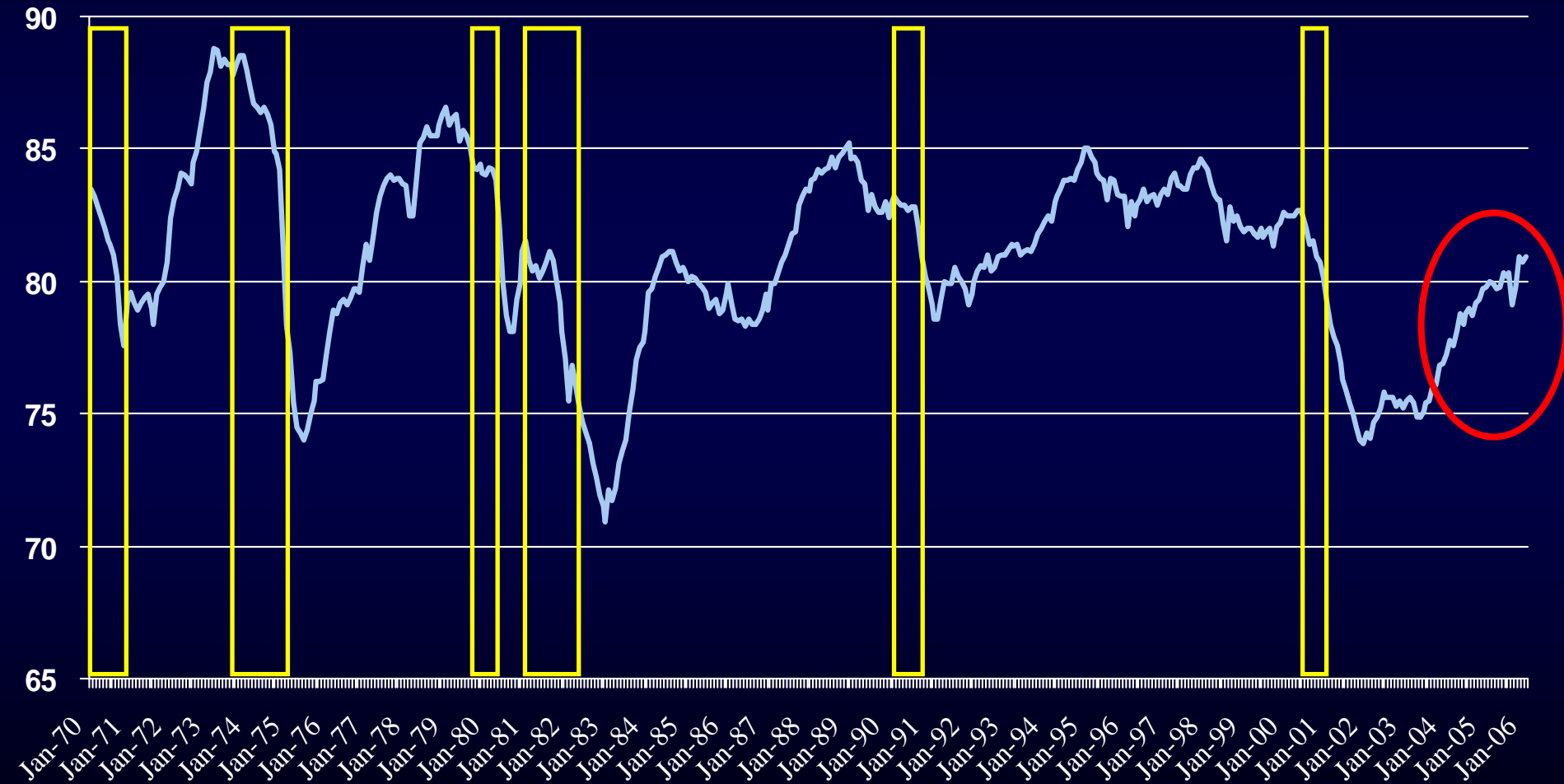
**Business spending has been stingy, except for equipment.**



# Capacity Utilization Rate

## 1970 – 2006\*

Source: The Conference Board

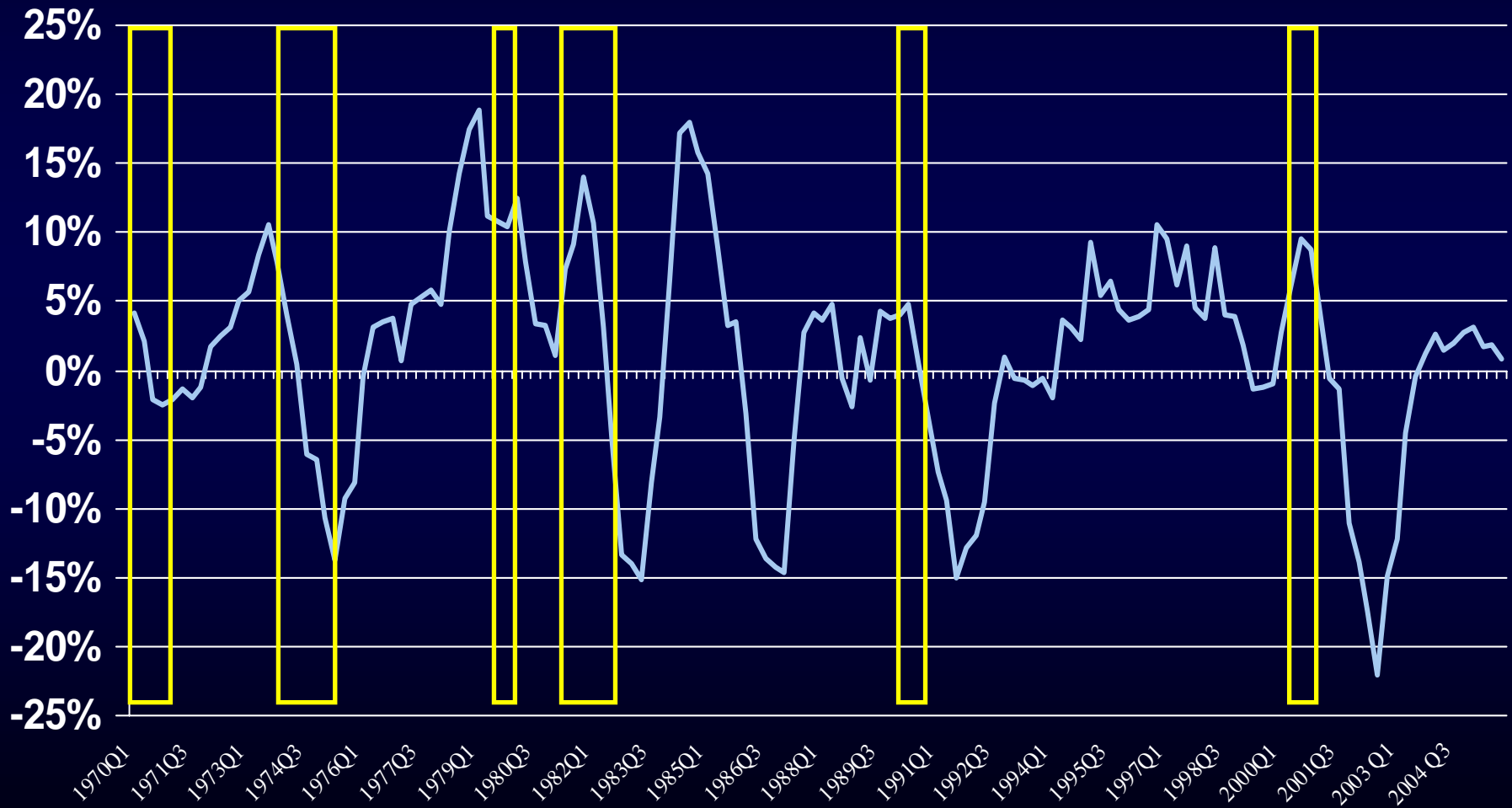


•Data through January 2006

 Recession Periods

# Total Plant Spending Percent Change Year Ago (Real Dollars) 1970 – 2005\*

Source: Bureau of Economic Analysis



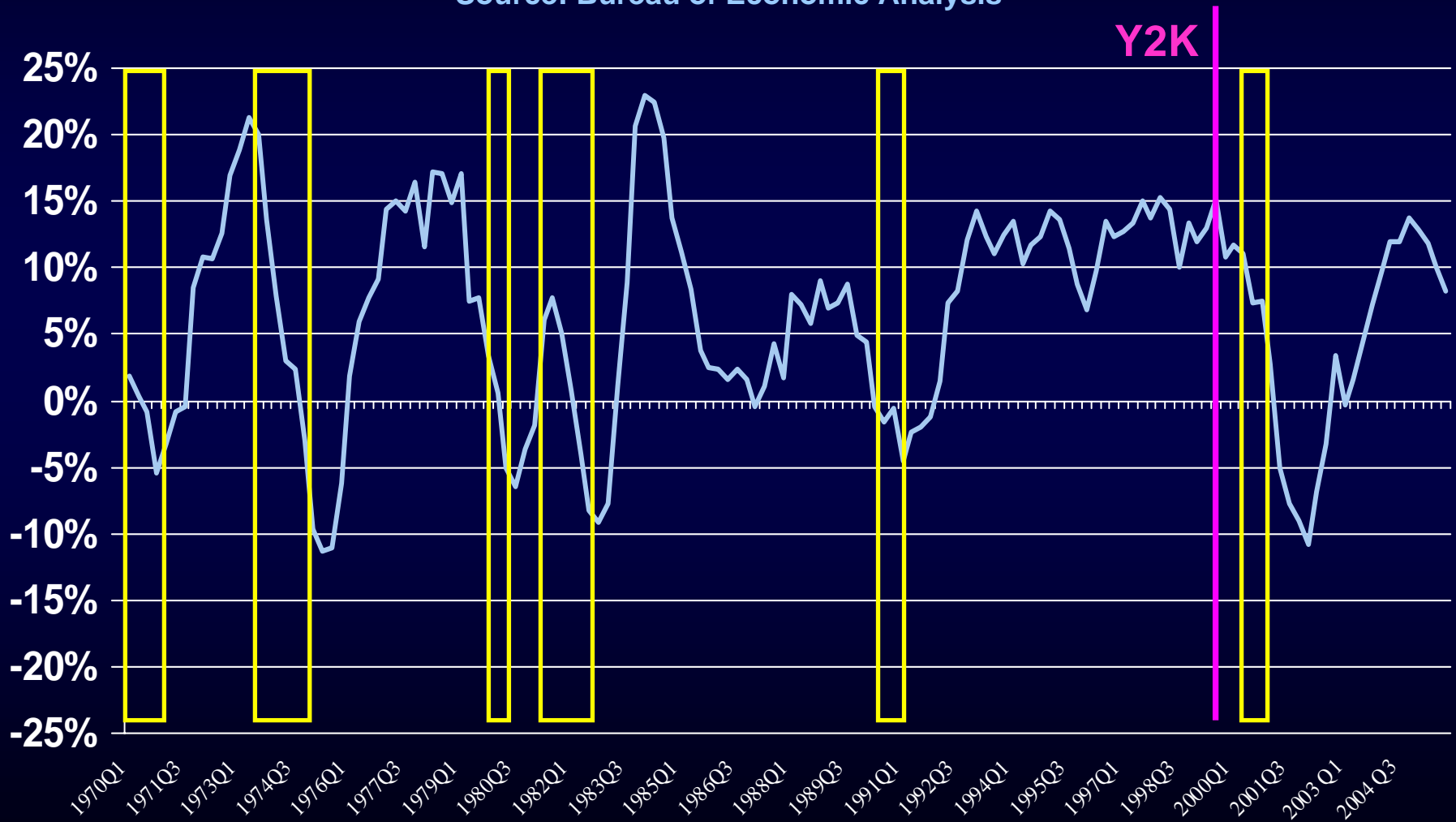
•Data through fourth quarter 2005.

•NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.

 **Recession Periods**

# Total Equipment & Software Spending Percent Change Year Ago (Real Dollars) 1970 – 2005\*

Source: Bureau of Economic Analysis



Y2K

 Recession Periods

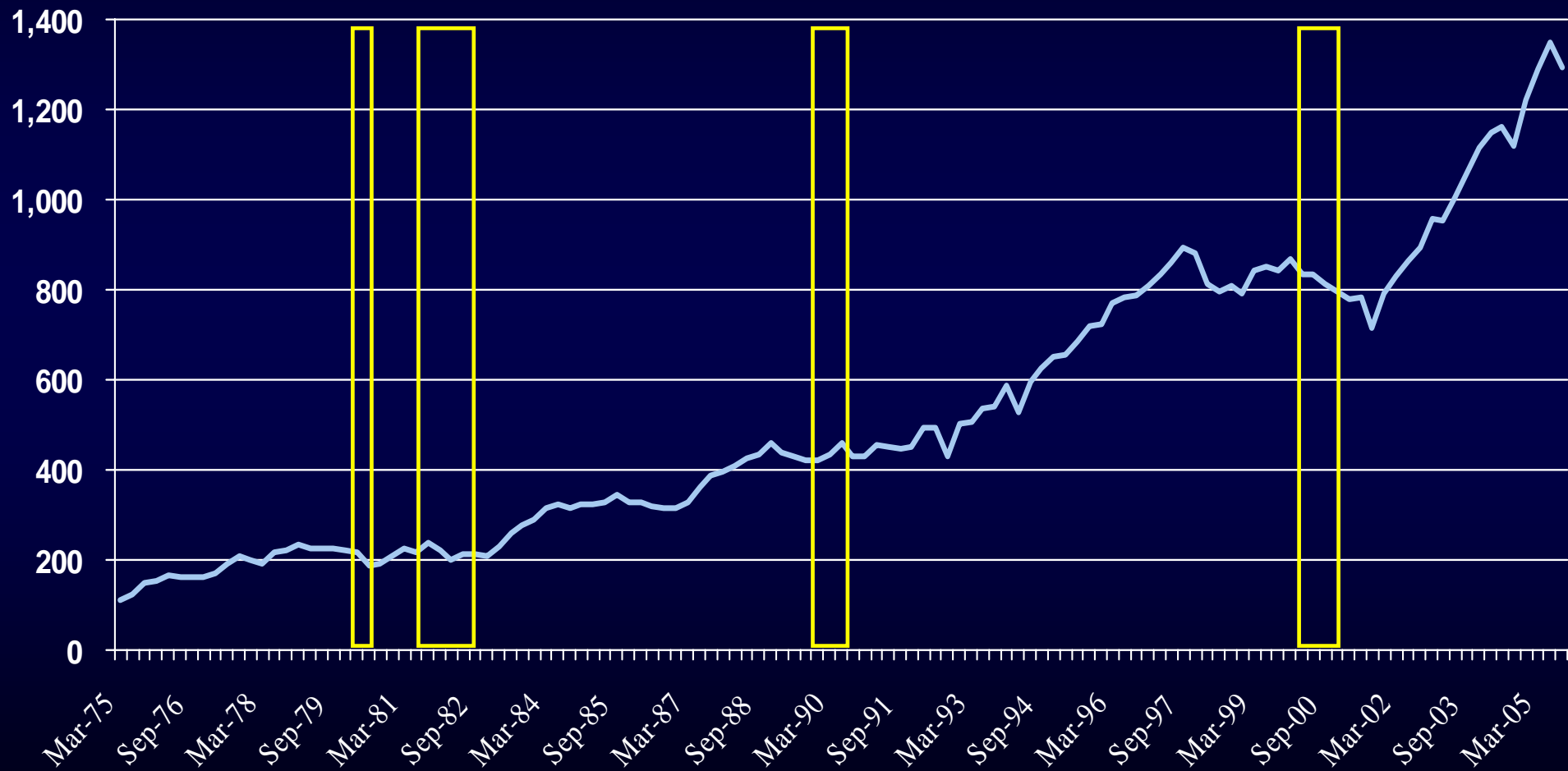
•Data through fourth quarter 2005.

•NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.

# Corporate Profit 1975-2005\*

(Billions of Dollars, SA)

Source: Freelunch.com



•Data through third quarter 2005

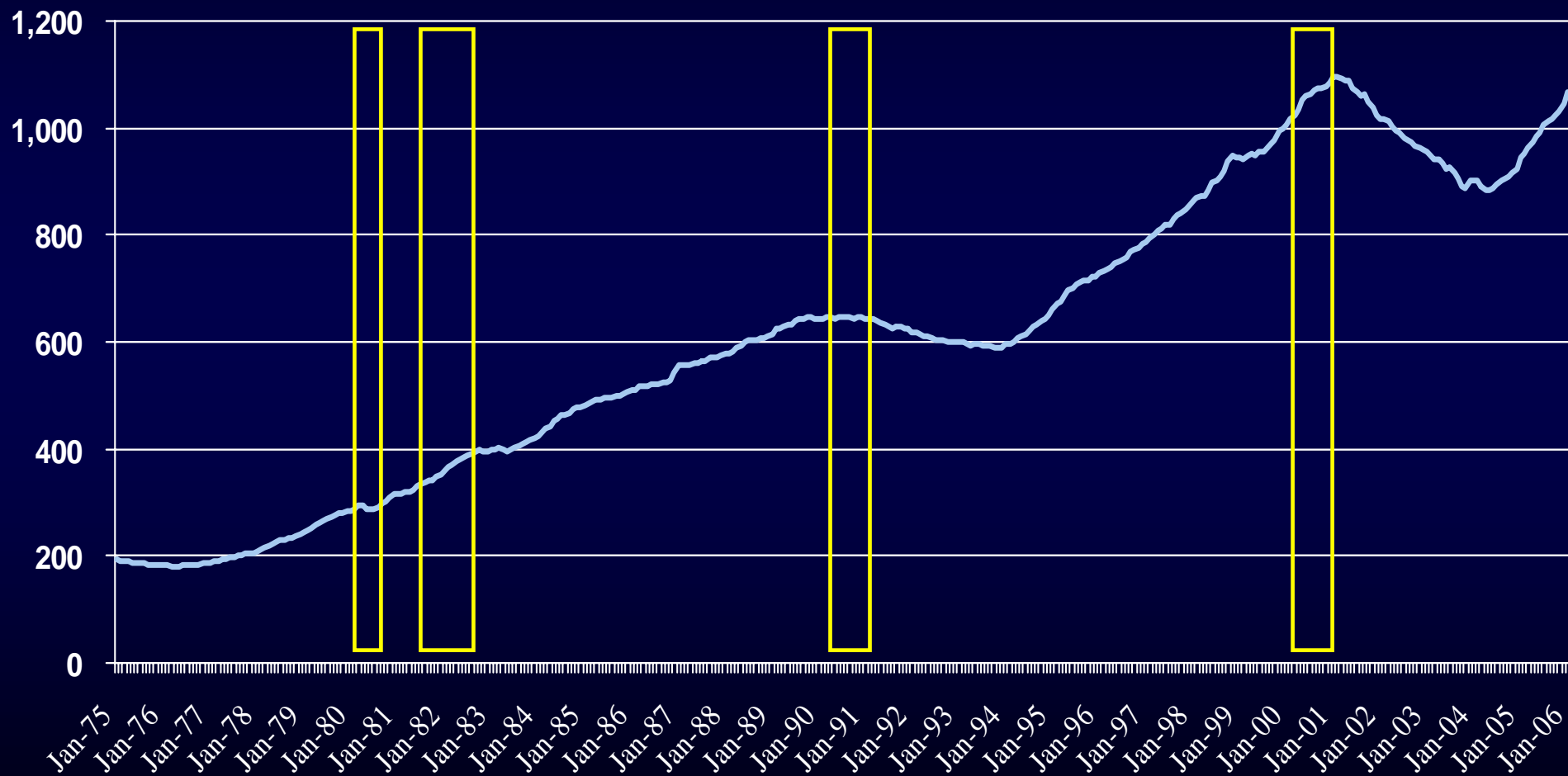
 Recession Periods

# Commercial & Industrial Loans, U.S. Based Banks

## 1975-2006\*

(Billions of Dollars, SA)

Source: Federal Reserve Economic Database

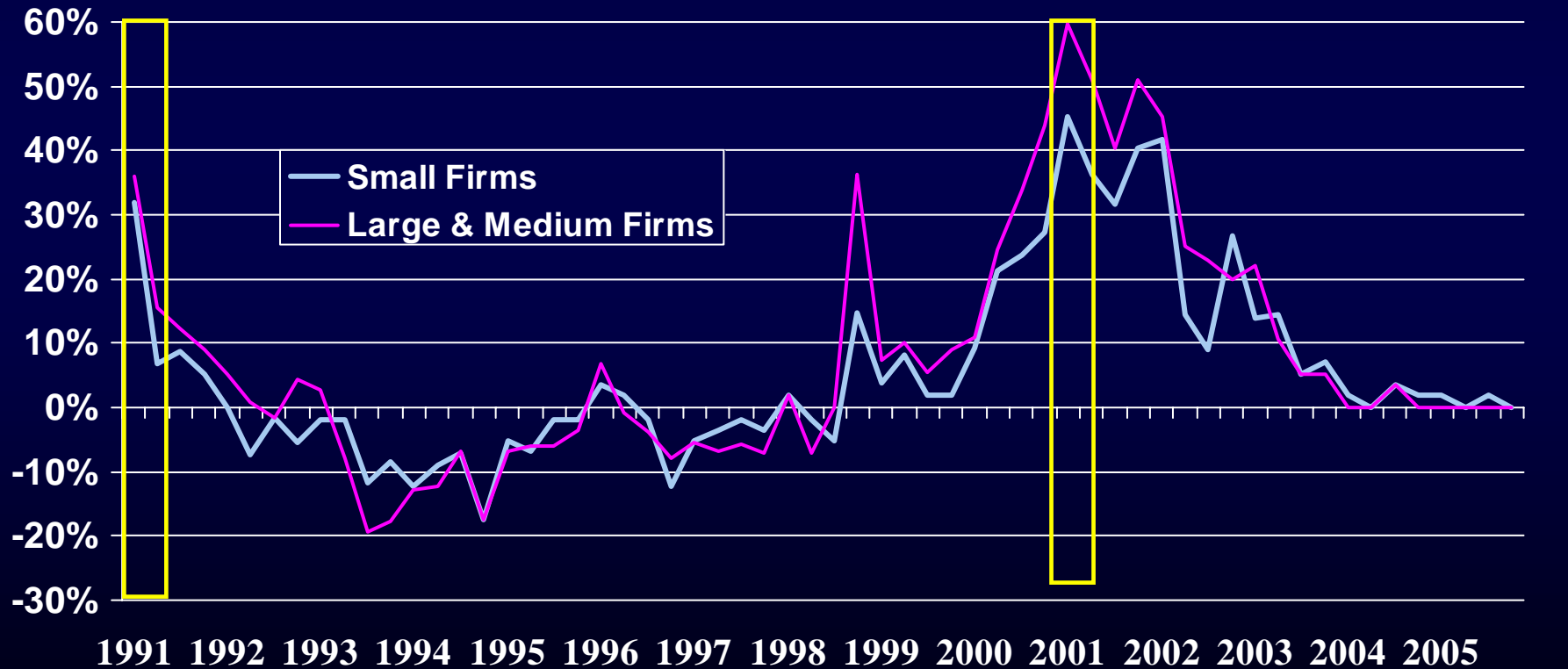


•Data through January 2006.

 Recession Periods

# Net Percentage of Large U.S. Banks Reporting Tougher Standards on Business Loans 1991 – 2005

Source: Federal Reserve, Board of Governors



 Recession Periods

# Government



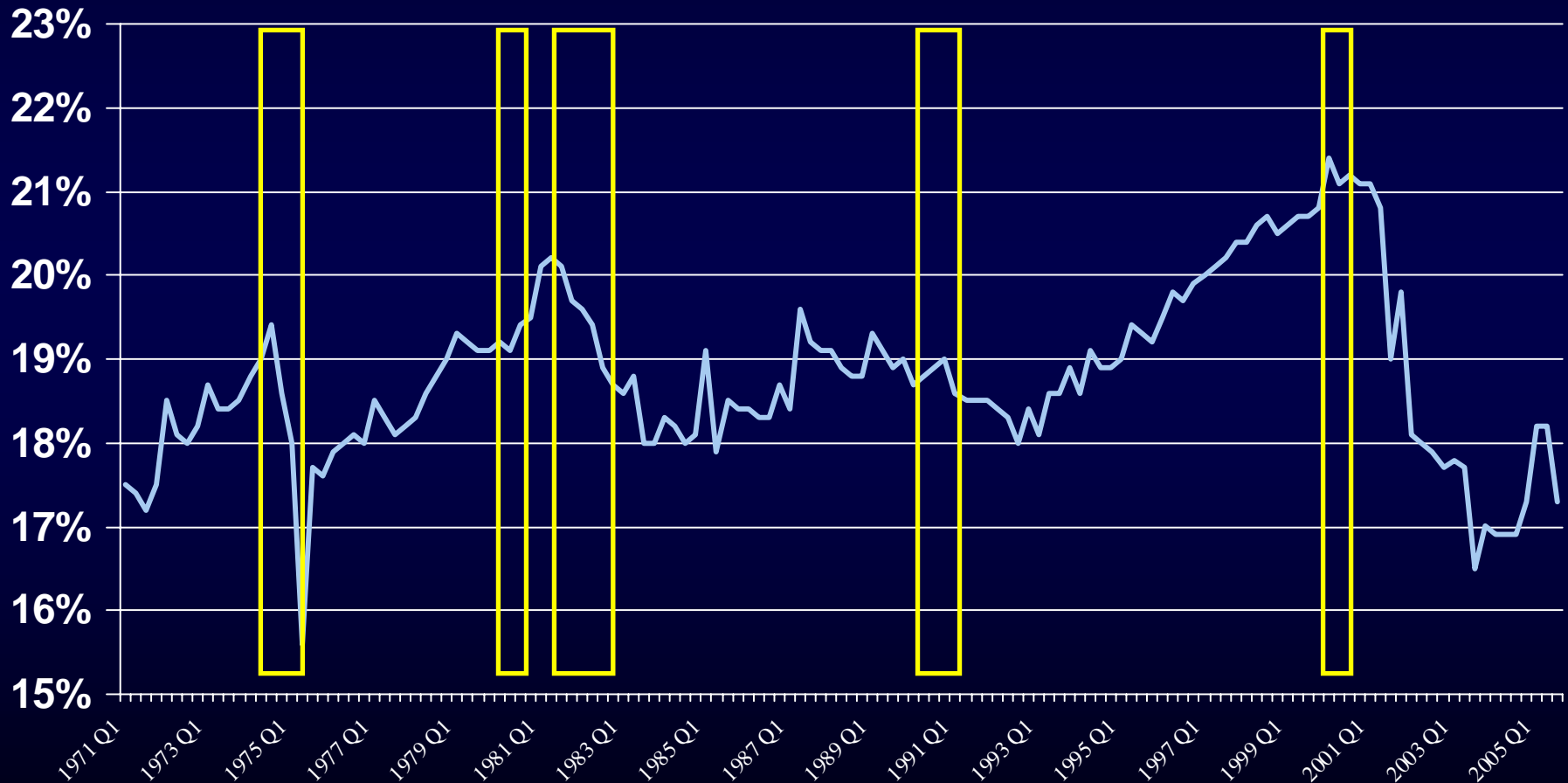
**Deficit ?**



# Federal Receipts as a Percent of GDP

1971 – 2005\*

Source: Bureau of Economic Analysis



\*Data through third quarter 2005

 Recession Periods

# Federal Expenditures as a Percent of GDP

1971 – 2005\*

Source: Bureau of Economic Analysis



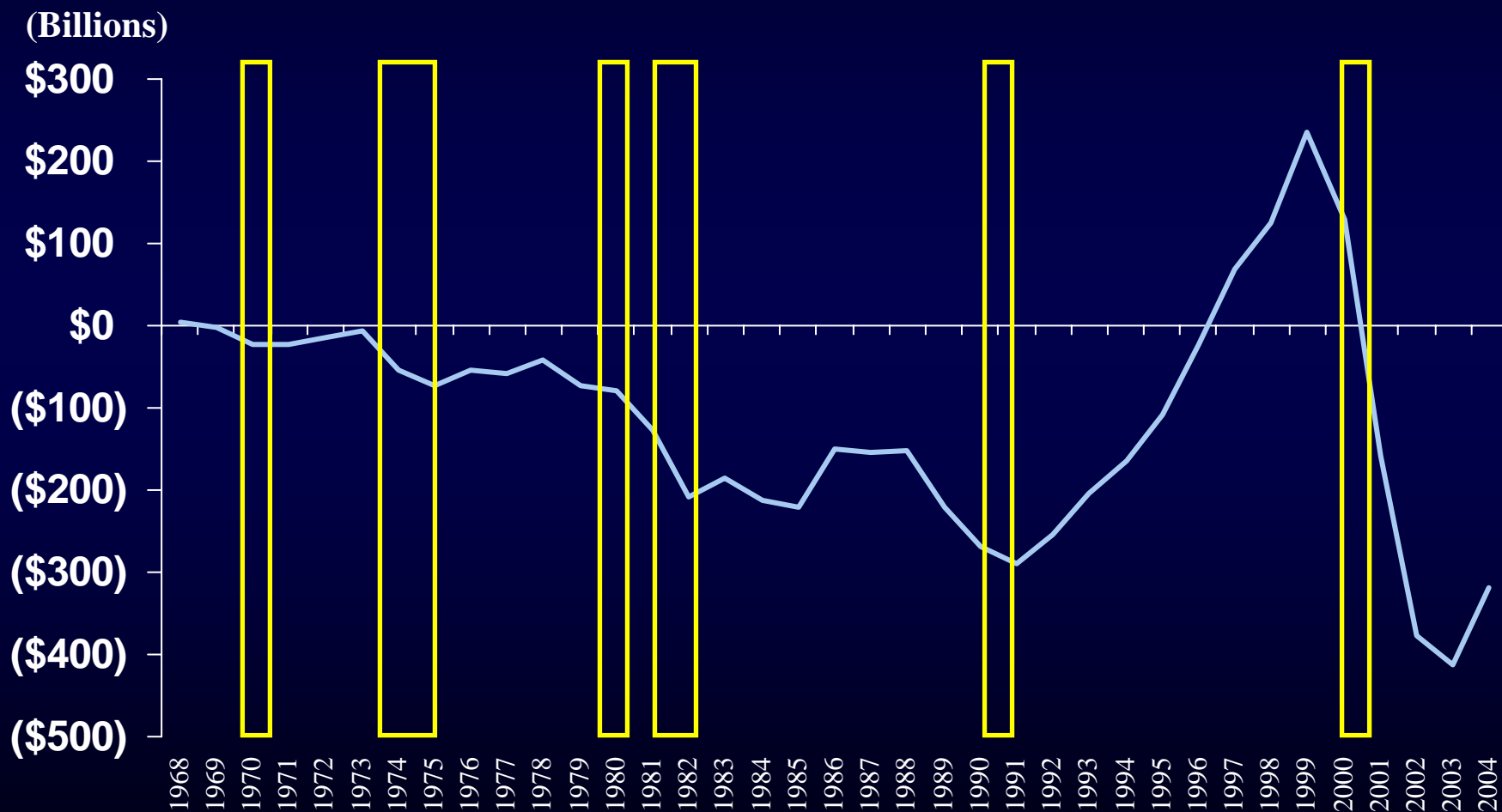
\*Data through third quarter 2005

 Recession Periods

# U.S. Federal Surplus/(Deficit)

## 1968 – 2004

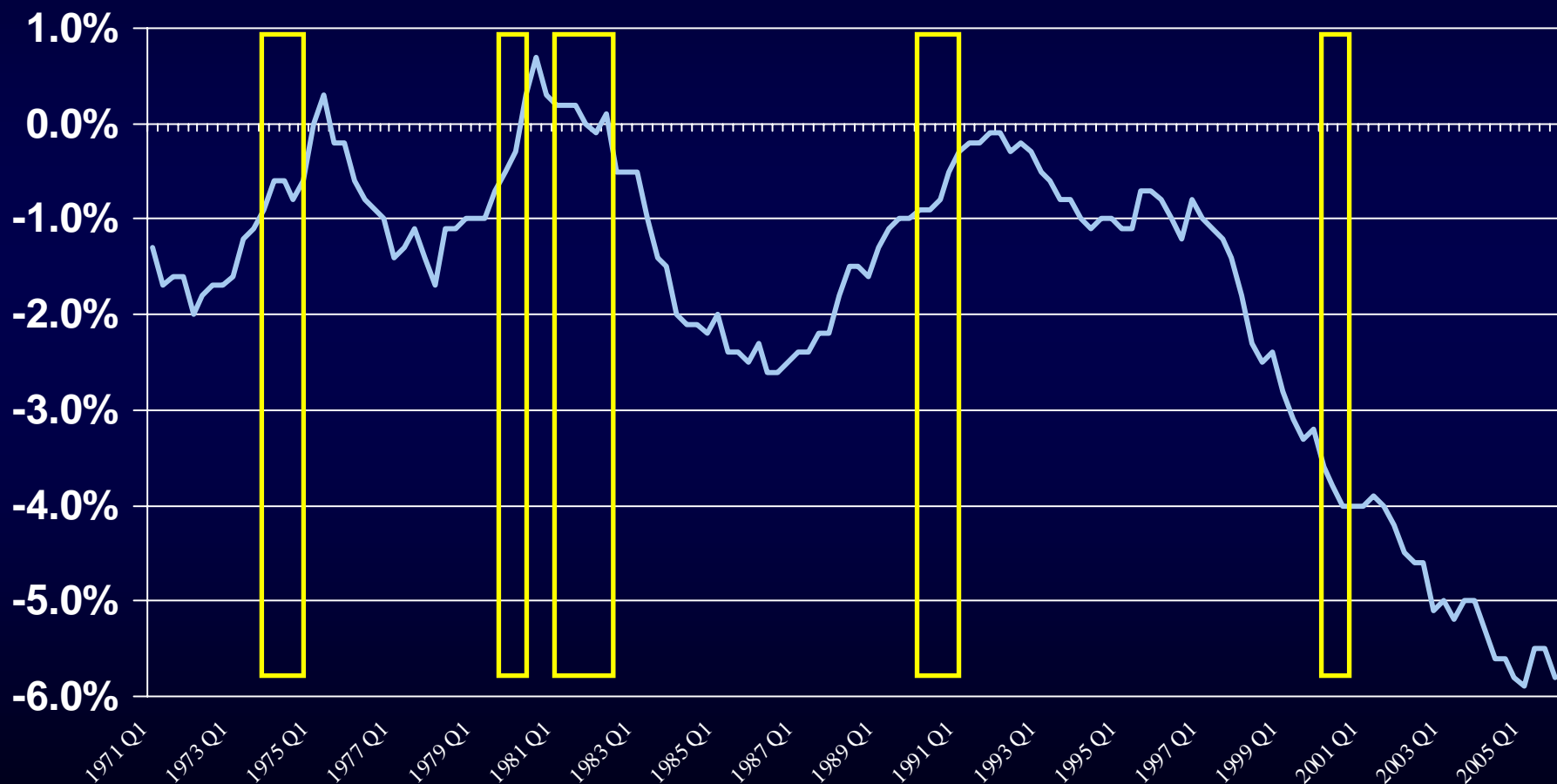
Source: White House Office of Management and Budget



# U.S. Real Net Exports as a Percent of Real GDP

1971 – 2005\*

Source: Bureau of Economic Analysis



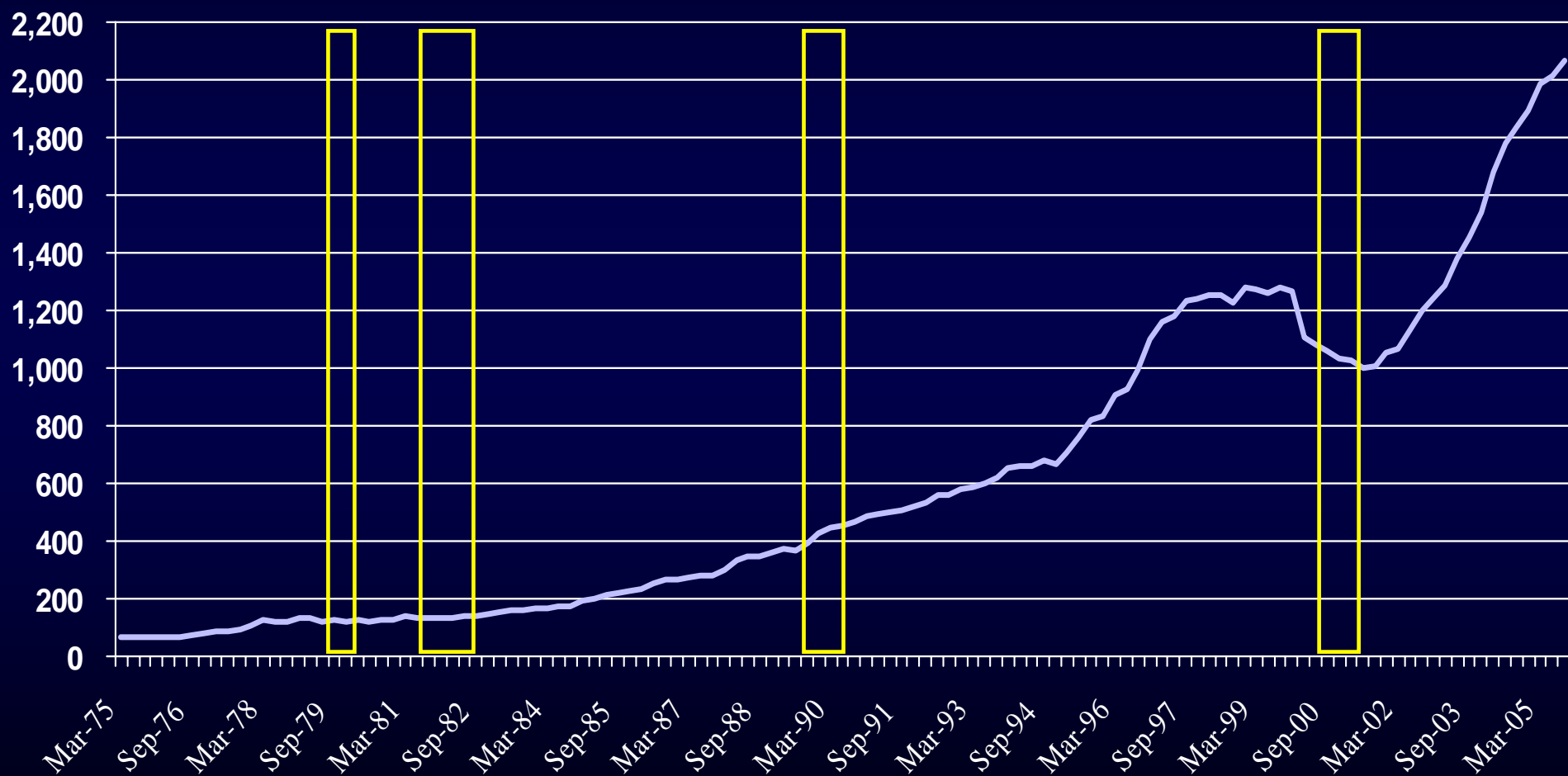
\*Data through fourth quarter 2005

 Recession Periods

# U.S. Debt Held by Foreign & International Investors 1975-2005\*

(Billions of Dollars, SA)

Source: Federal Reserve Economic Database



•Data through third quarter 2005.

# U.S. OUTLOOK

## 2005 vs. 2006

### LAST YEAR

- |  |        |                            |
|--|--------|----------------------------|
| ■ Fiscal stimulus                        | —————→ | ■ Not as much              |
| ■ Monetary stimulus                      | —————→ | ■ Strong (but not as much) |
| ■ Real incomes up                        | —————→ | ■ Still strong             |
| ■ Businesses mean and lean               | —————→ | ■ Still strong             |
| ■ Productivity growth strong             | —————→ | ■ Not as strong            |
| ■ Job growth accelerating, albeit slowly | →      | ■ Same                     |
| ■ Cheaper dollar means more exports      | →      | ■ Same                     |
| ■ Inflation (in near term) not a problem | →      | ■ Moving up slowly         |
| ■ Low interest rates                     | —————→ | ■ Moving up, but still low |

### THIS YEAR

# **U.S. Economy: The Glass is Half Full**

**... But not  
as full as  
last year.**





**So,  
what's  
the  
verdict?**



**Things look good.**



**ELLIOTT D. POLLACK**  
**& Company**

*Economic and Real Estate Consulting*

**WWW.ARIZONAECONOMY.COM**

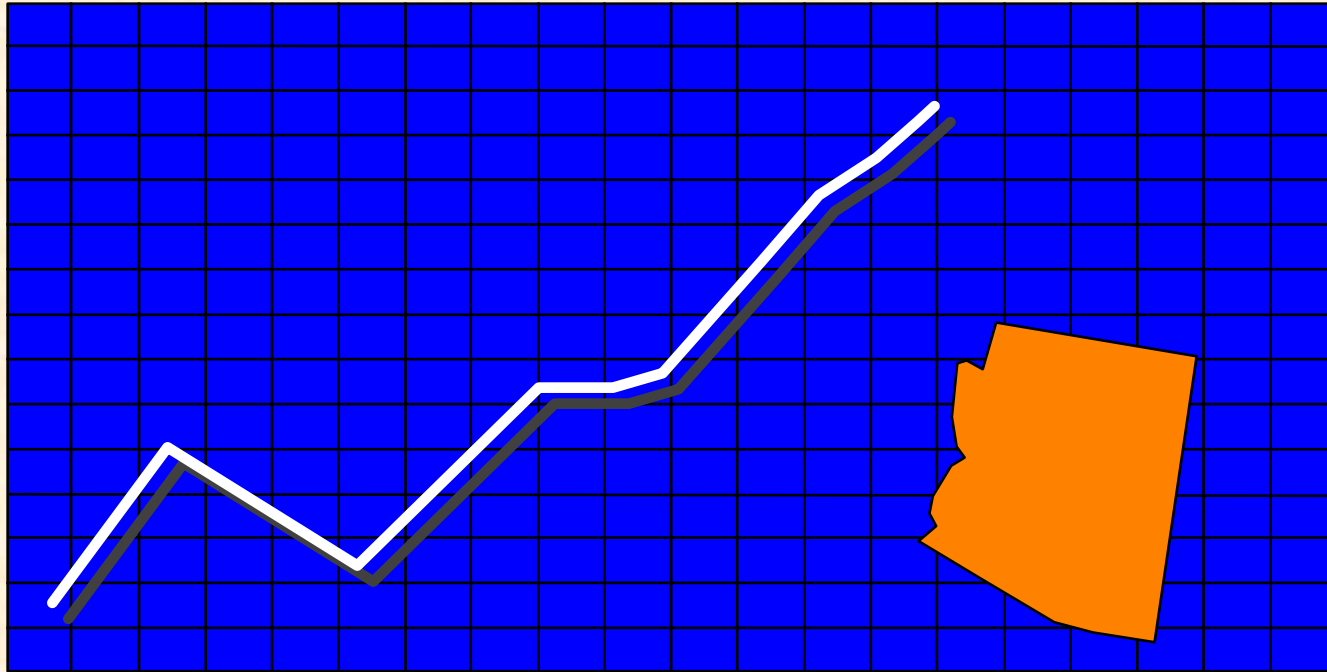
**INFO @ EDPCO.COM**

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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)**

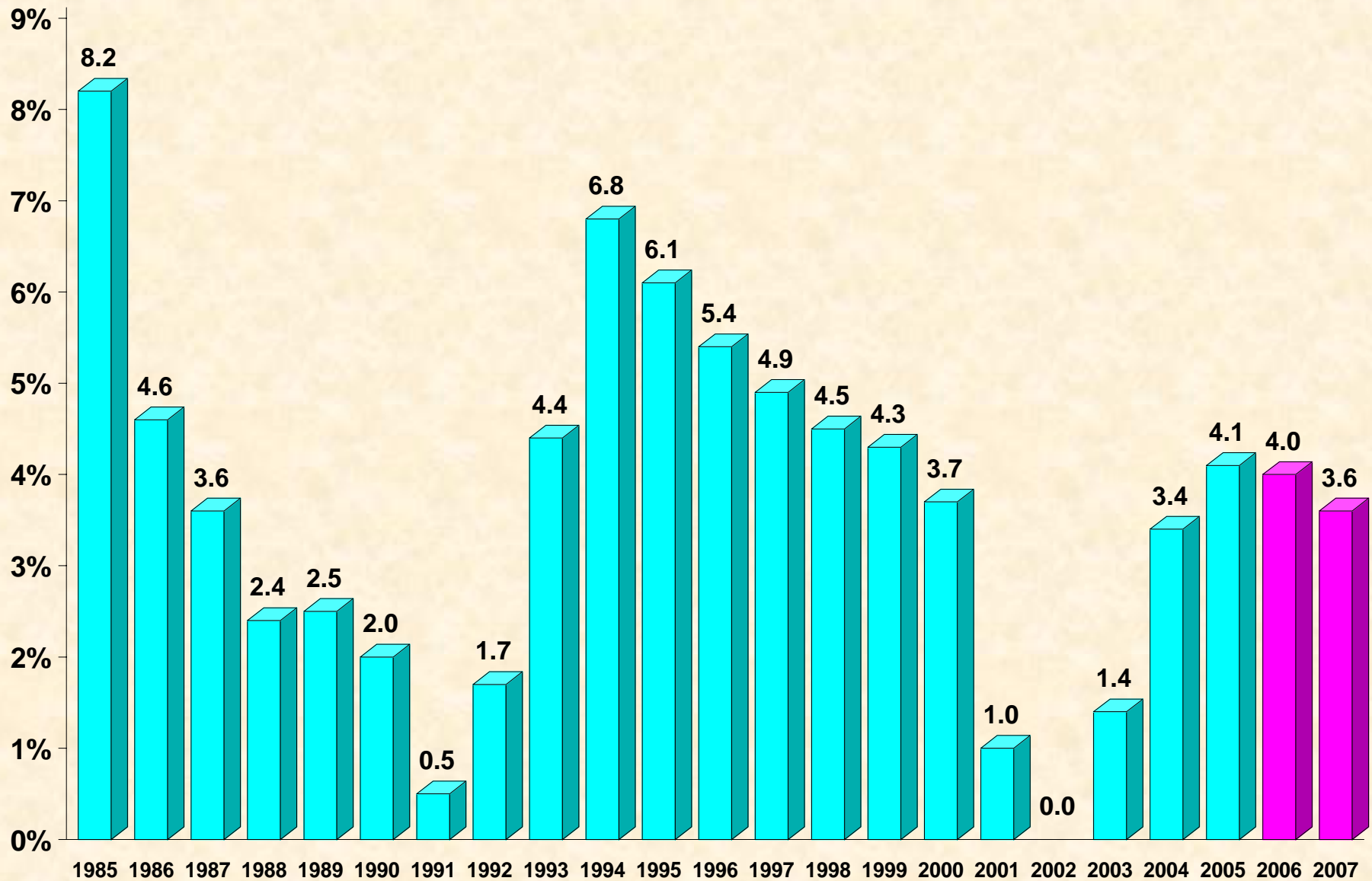
# Arizona

## Update and Outlook



**Bank One Economic Outlook Center**

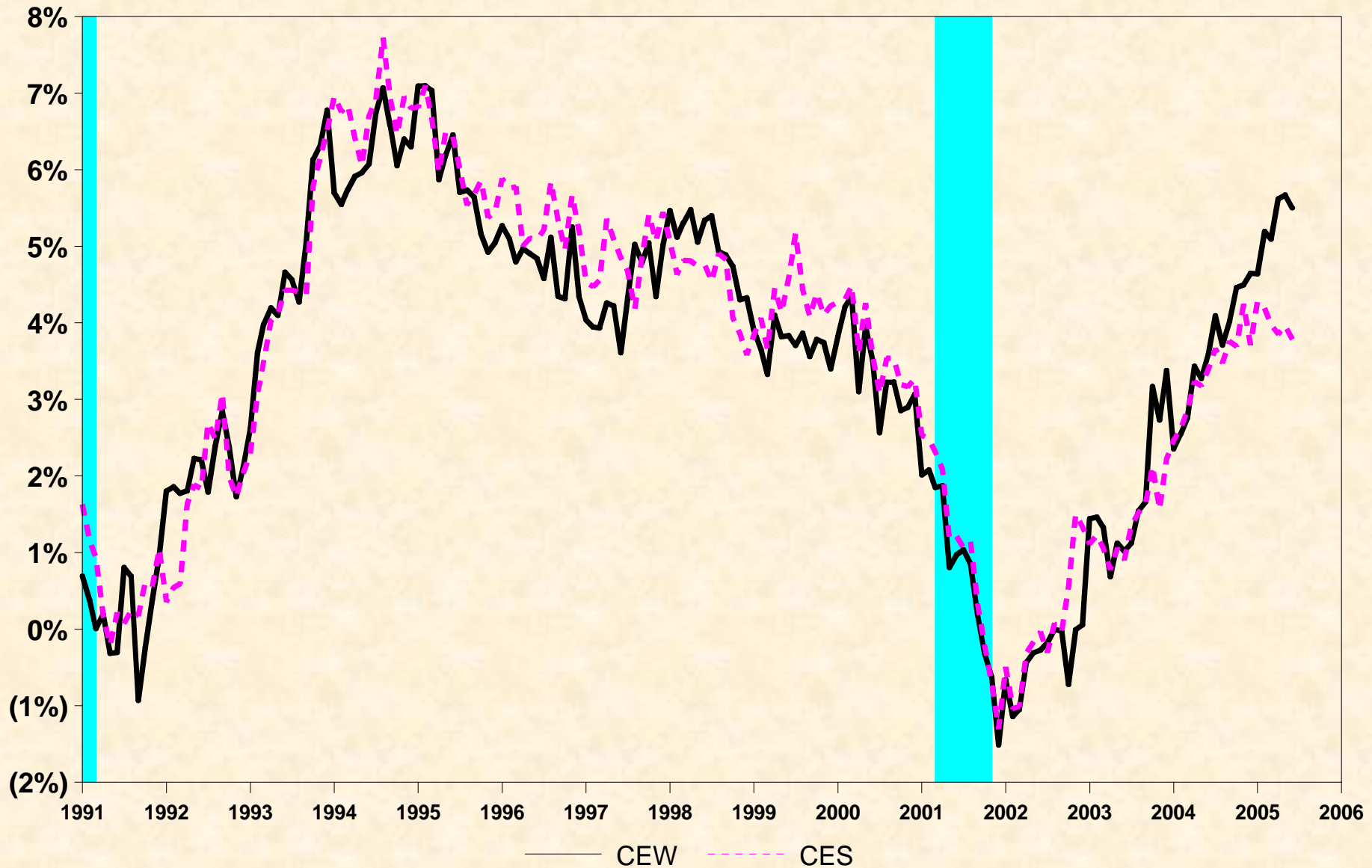
# Arizona Wage and Salary Employment Growth



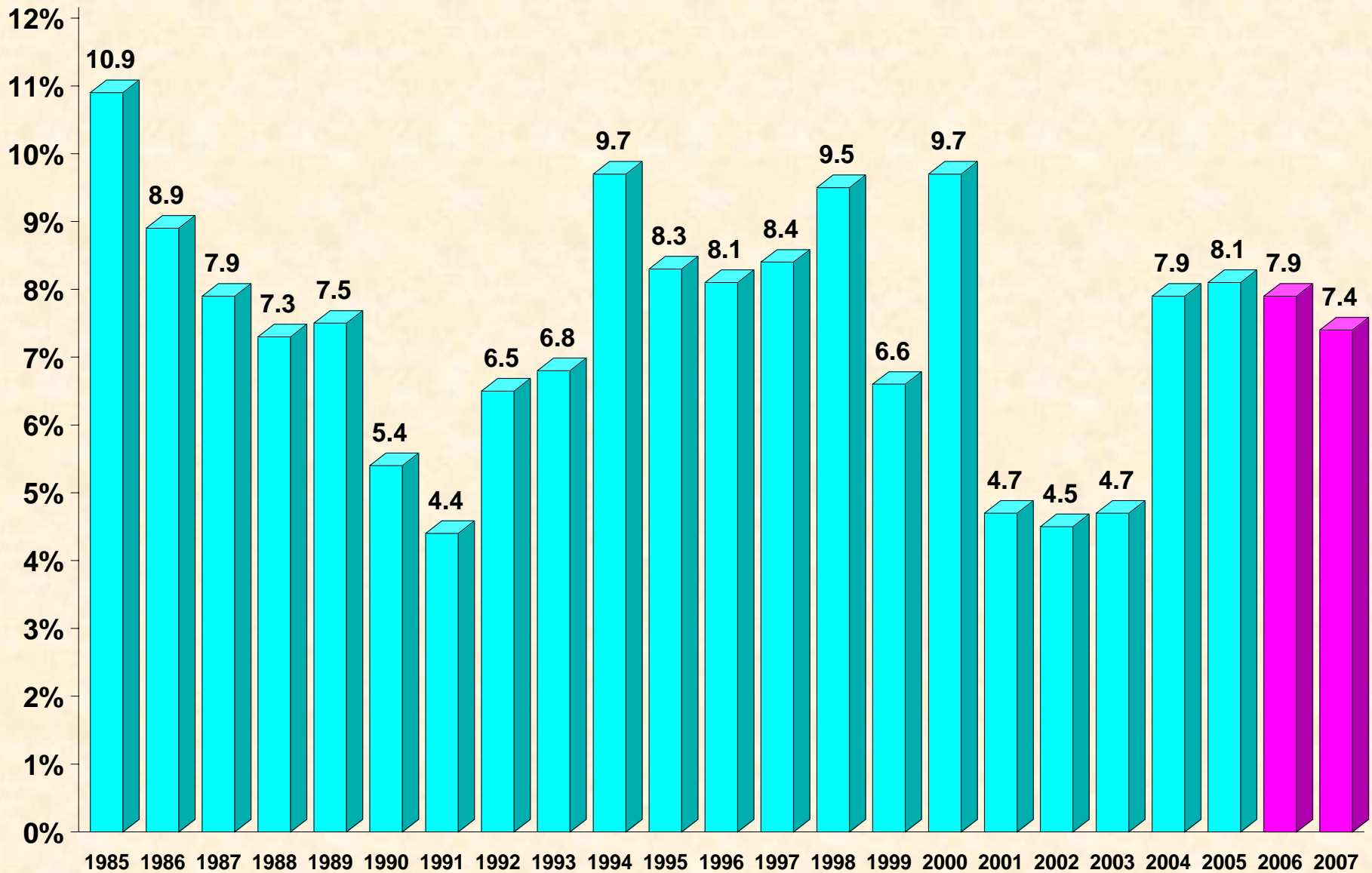
History: Arizona Department of Economic Security (percent change)

Forecasts are from the January Bank One Arizona Blue Chip Economic Forecast

# Potential for Employment Revisions 1991 to 2005



# Arizona Personal Income Growth



History: Bureau of Economic Analysis (percent change)

Forecasts are from the January Bank One Arizona Blue Chip Economic Forecast

# Quarterly Census of Employment and Wages [QCEW or ES-202]

## QUARTERLY TOTAL WAGES BY BLS SUPERSECTOR

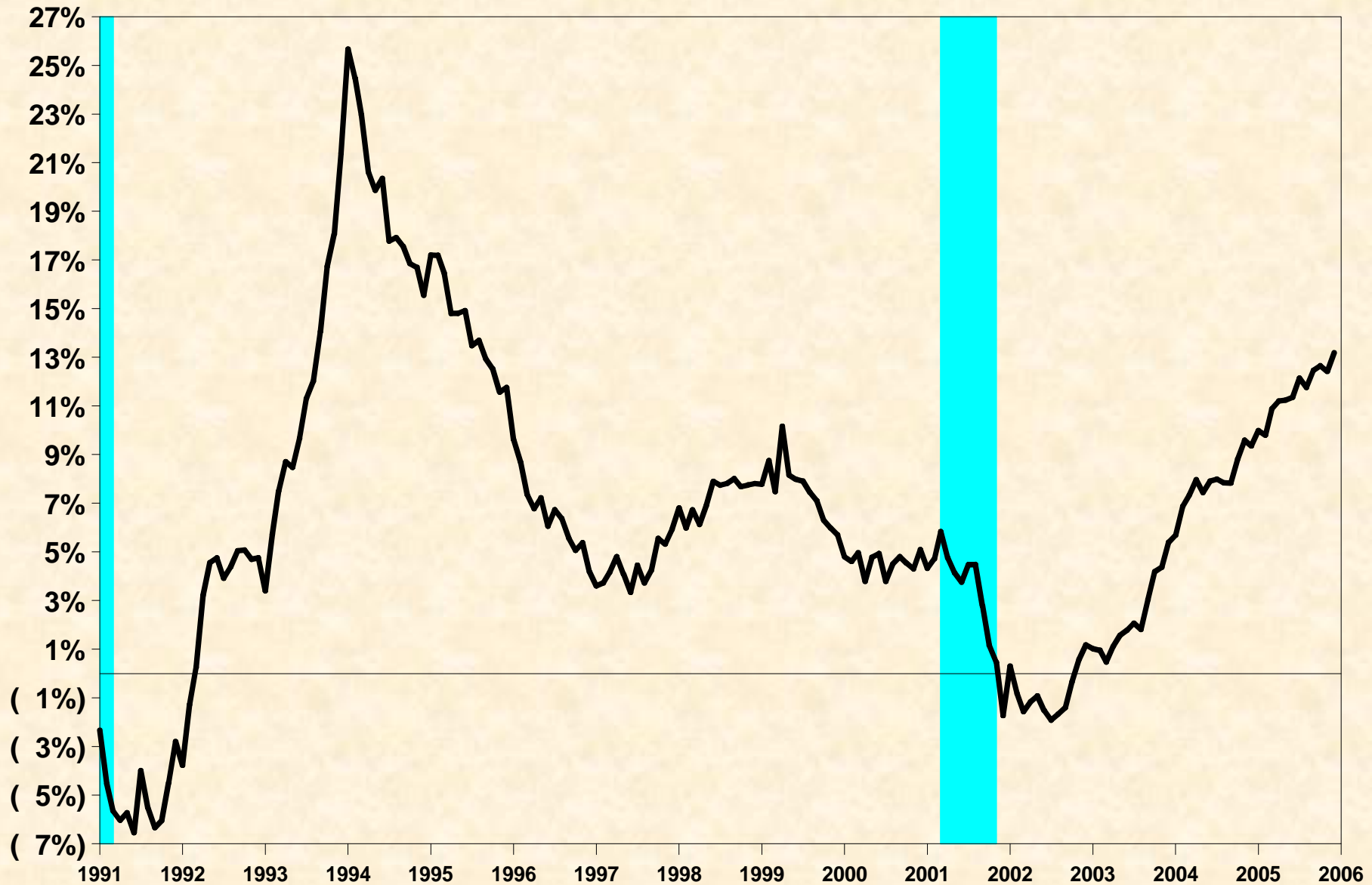
BLS Supersectors	3q2004	% of Total	3q2005	% of Total	OTY Change	% of Total	OTY % Chg
Total	\$20,875,688,710	100.0%	\$23,928,106,215	100.0%	\$3,052,417,505	100.0%	14.62%
Private Sector	\$17,495,494,802	83.8%	\$20,149,618,449	84.2%	\$2,654,123,647	87.0%	15.17%
Goods-Producing	\$4,224,221,924	20.2%	\$4,894,354,197	20.5%	\$670,132,273	22.0%	15.86%
Natural Resources & Mining	\$214,978,661	1.0%	\$222,363,039	0.9%	\$7,384,378	0.2%	3.43%
Construction	\$1,712,668,976	8.2%	\$2,162,210,847	9.0%	\$449,541,871	14.7%	26.25%
Manufacturing	\$2,296,574,287	11.0%	\$2,509,780,311	10.5%	\$213,206,024	7.0%	9.28%
Durable	\$1,993,723,307	9.6%	\$2,186,731,018	9.1%	\$193,007,711	6.3%	9.68%
Non-Durable	\$302,850,980	1.5%	\$323,049,293	1.4%	\$20,198,313	0.7%	6.67%
Service-Providing	\$16,651,466,786	79.8%	\$19,033,752,018	79.5%	\$2,382,285,232	78.0%	14.31%
Trade, Transportation & Utilities	\$3,952,457,088	18.9%	\$4,479,800,128	18.7%	\$527,343,040	17.3%	13.34%
Total Trade	\$3,125,000,688	15.0%	\$3,585,767,059	15.0%	\$460,766,371	15.1%	14.74%
Wholesale Trade	\$1,241,938,297	5.9%	\$1,409,731,546	5.9%	\$167,793,249	5.5%	13.51%
Retail Trade	\$1,883,062,391	9.0%	\$2,176,035,513	9.1%	\$292,973,122	9.6%	15.56%
Transportation, Warehousing & Utilities	\$827,456,400	4.0%	\$894,033,069	3.7%	\$66,576,669	2.2%	8.05%
Information	\$522,097,187	2.5%	\$565,590,759	2.4%	\$43,493,572	1.4%	8.33%
Financial Activities	\$1,856,877,083	8.9%	\$2,269,166,564	9.5%	\$412,289,481	13.5%	22.20%
Professional & Business Services	\$3,072,105,173	14.7%	\$3,544,792,848	14.8%	\$472,687,675	15.5%	15.39%
Education & Health Care	\$2,446,437,247	11.7%	\$2,772,169,049	11.6%	\$325,731,802	10.7%	13.31%
Leisure & Hospitality	\$983,002,702	4.7%	\$1,107,445,992	4.6%	\$124,443,290	4.1%	12.66%
Other Services	\$404,721,898	1.9%	\$447,455,101	1.9%	\$42,733,203	1.4%	10.56%
Government	\$3,380,193,908	16.2%	\$3,778,487,766	15.8%	\$398,293,858	13.0%	11.78%
Unclassified	\$33,574,500	0.2%	\$68,843,811	0.3%	\$35,269,311	1.2%	105.05%

## QUARTERLY TOTAL WAGES BY BLS SUPERSECTOR

6

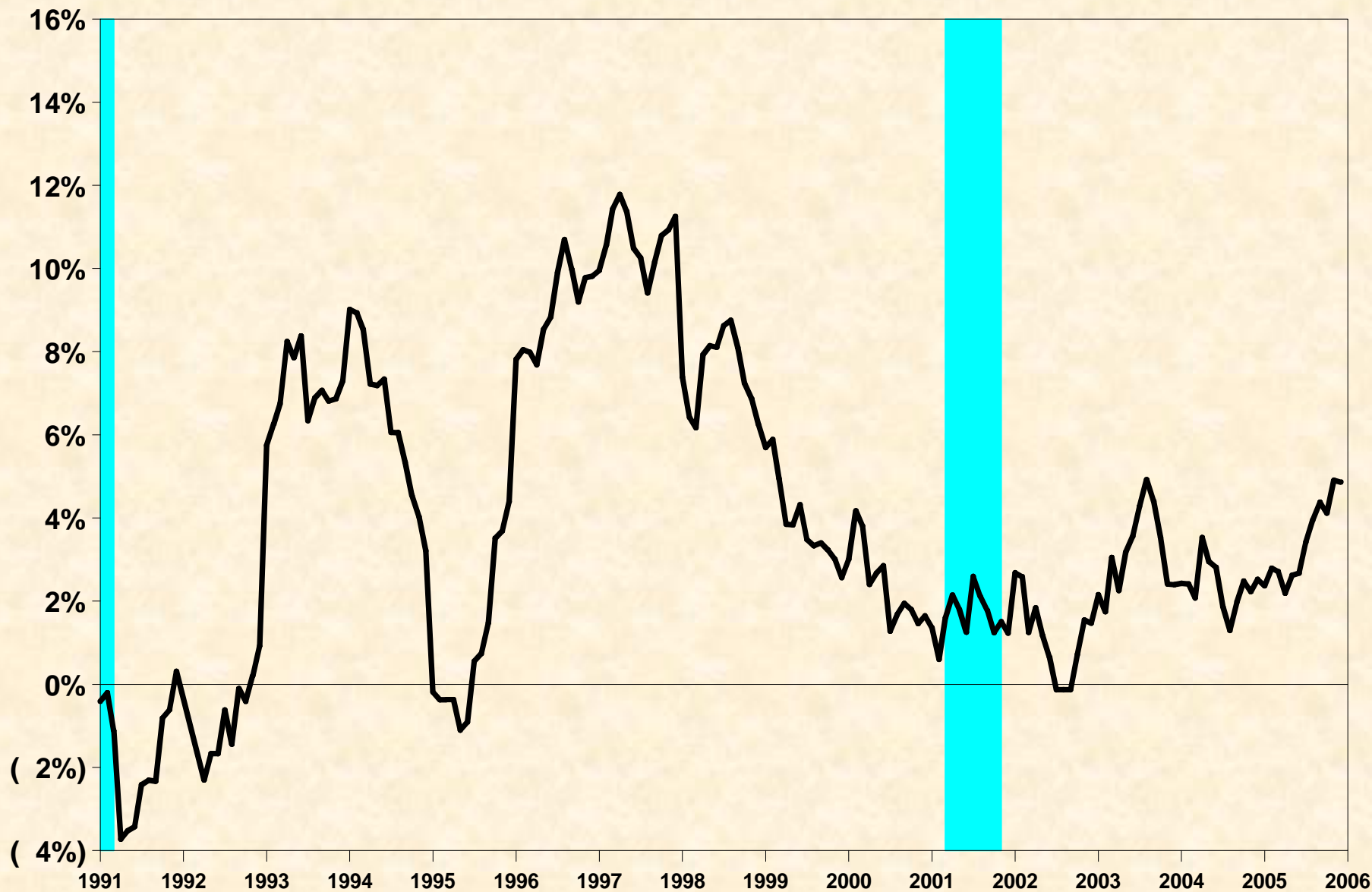


# Arizona Construction Employment Growth 1991 to 2005



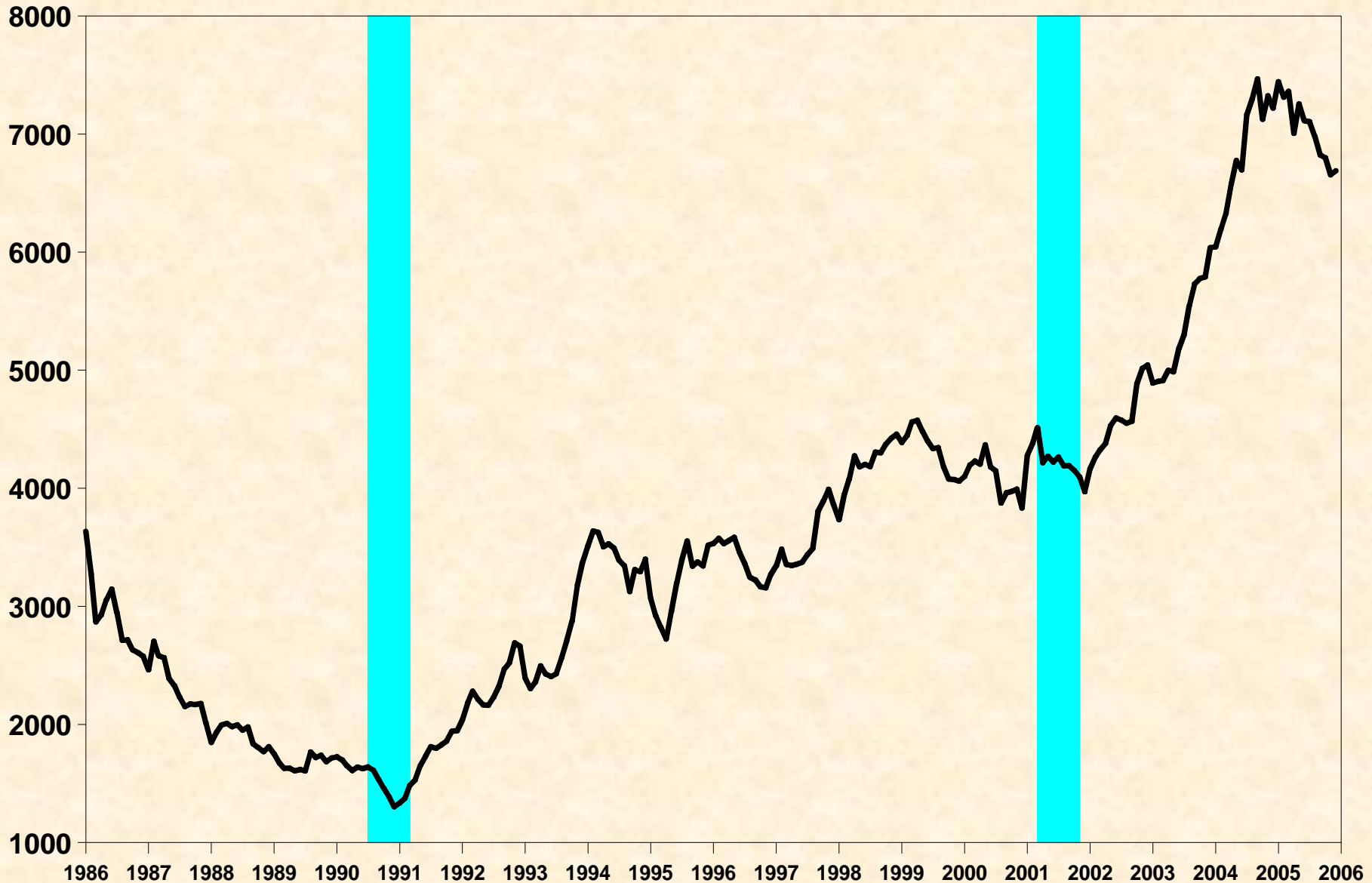
Source: Arizona Department of Economic Security (last data point December 2005= 13% )

# Arizona Financial Services Employment Growth 1991 to 2005



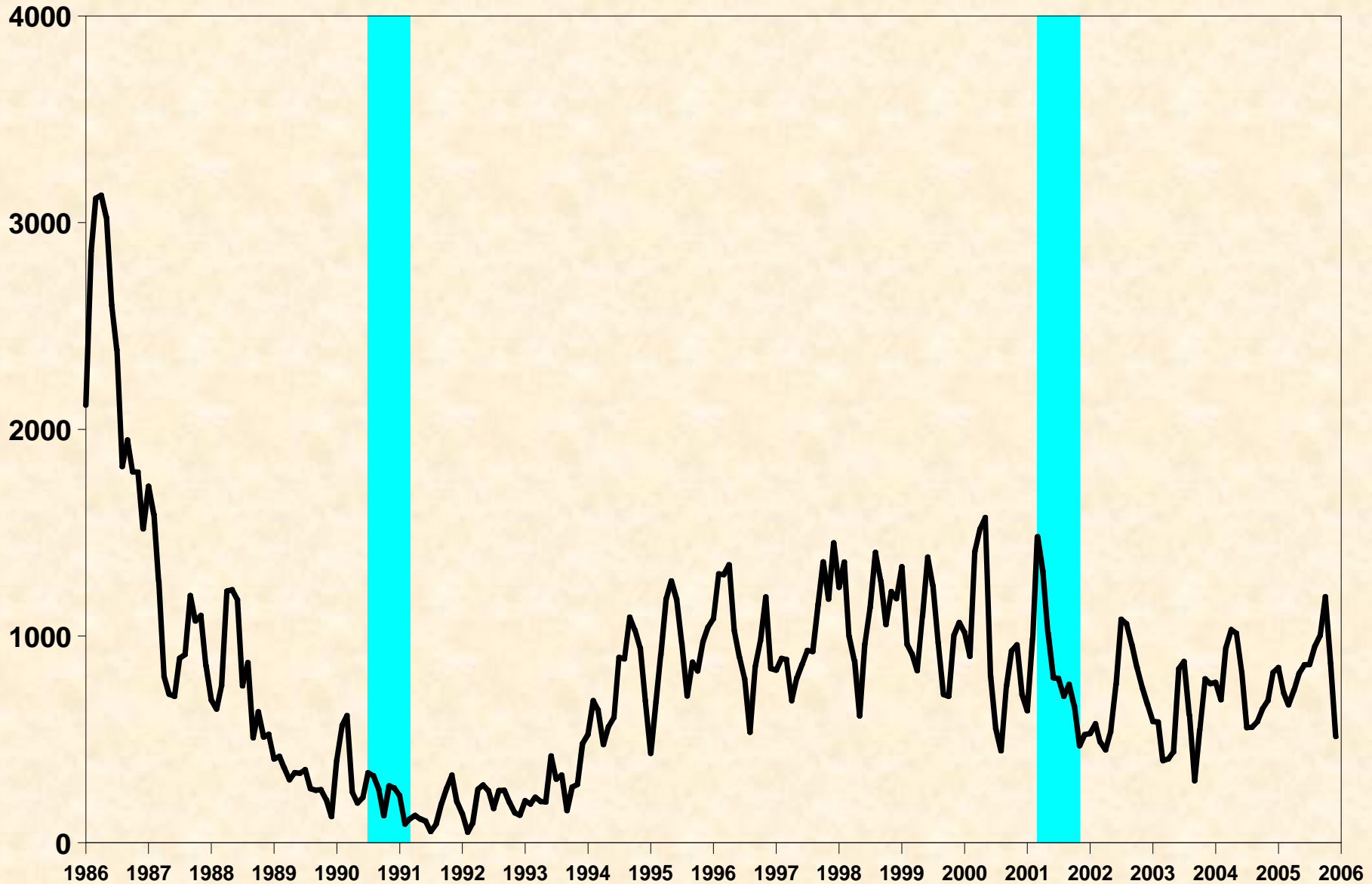
Source: Arizona Department of Economic Security (last data point December 2005= 4.9% )

# Arizona Single Family Permits 1986 to 2005



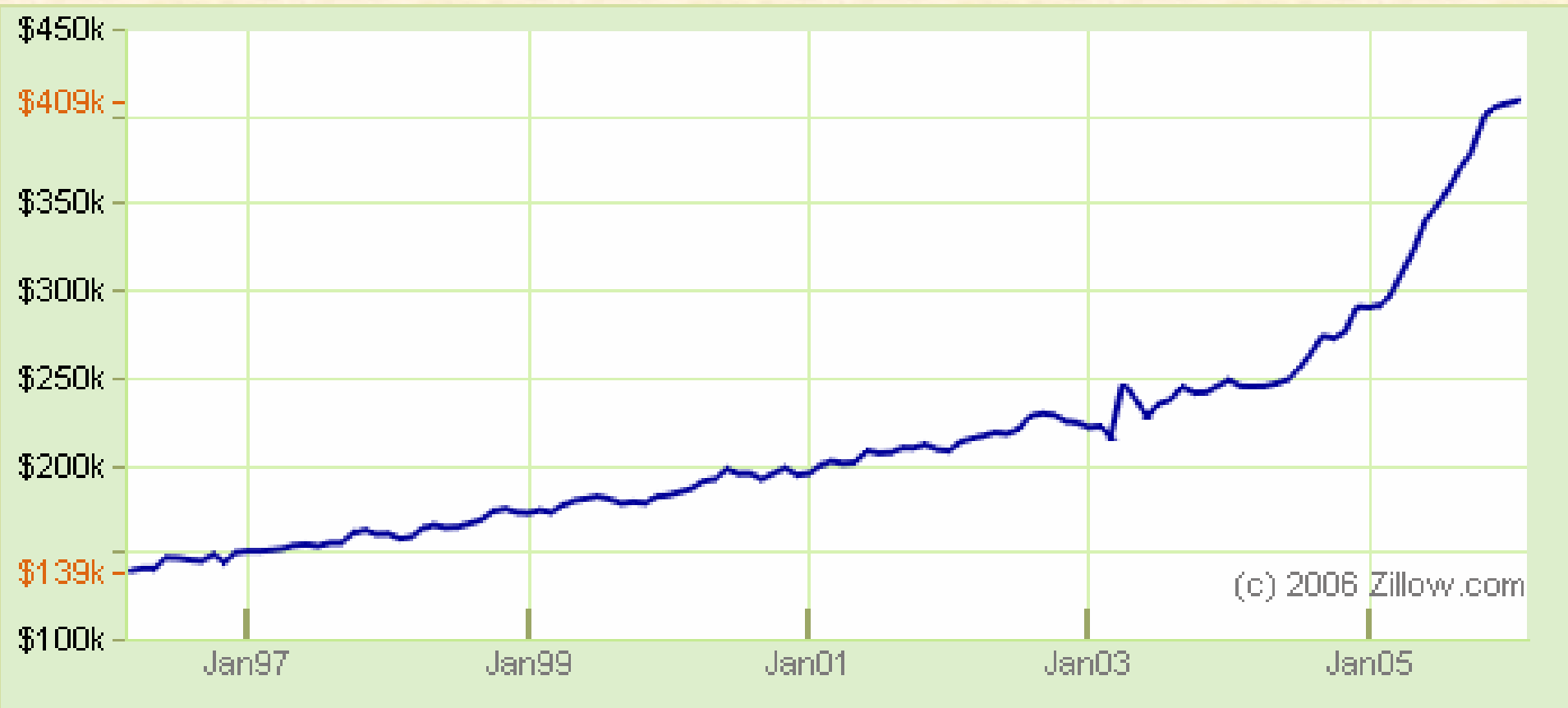
Source: Arizona Real Estate Center 3 MMA SA (last data point December 2005)

# Arizona Multi-Family Units Permitted 1986 to 2005



Source: Arizona Real Estate Center 3 MMA SA (last data point December 2005)

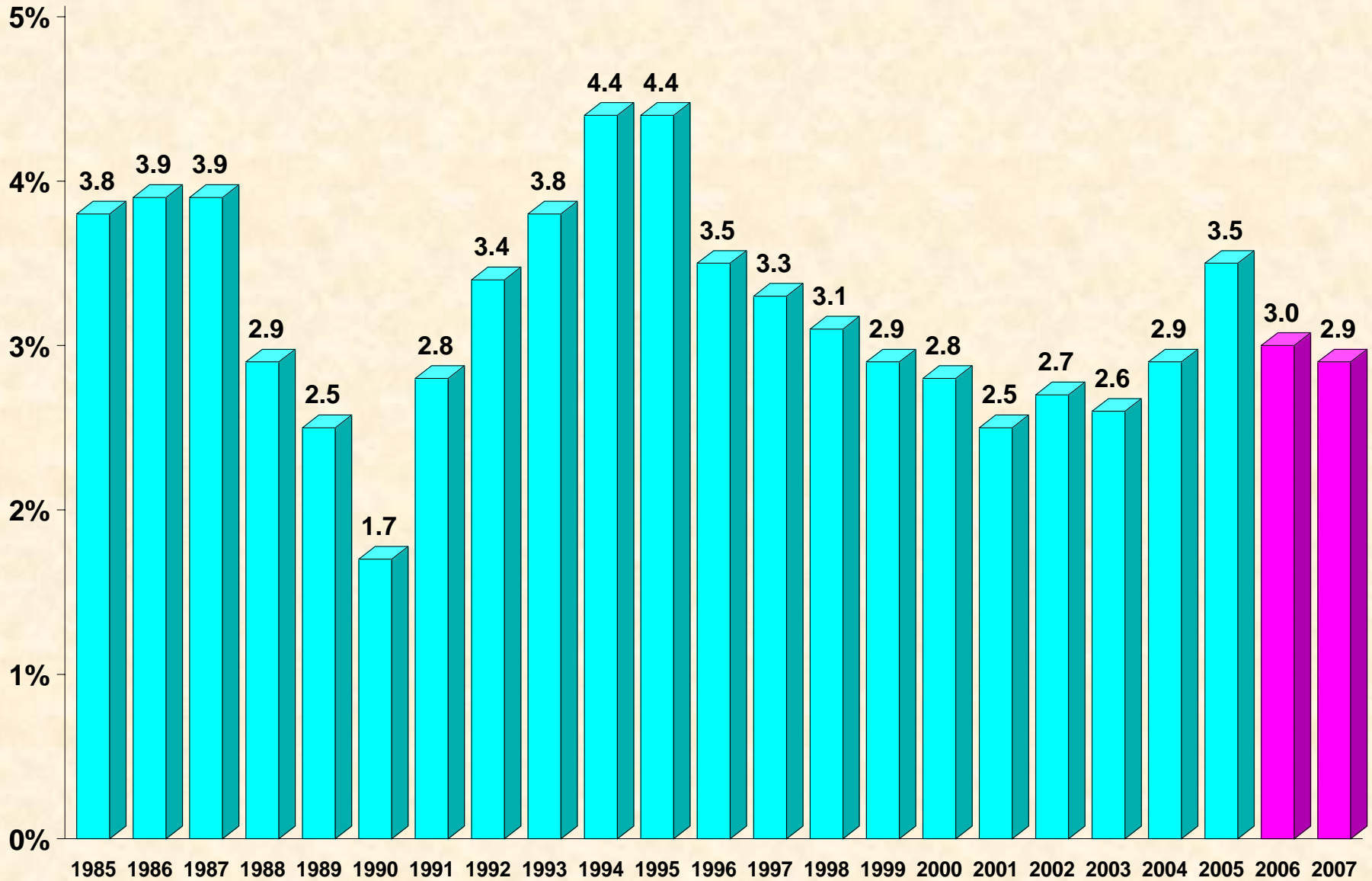
# Long Term Price Appreciation of my House



# Short Term Price Appreciation of my House



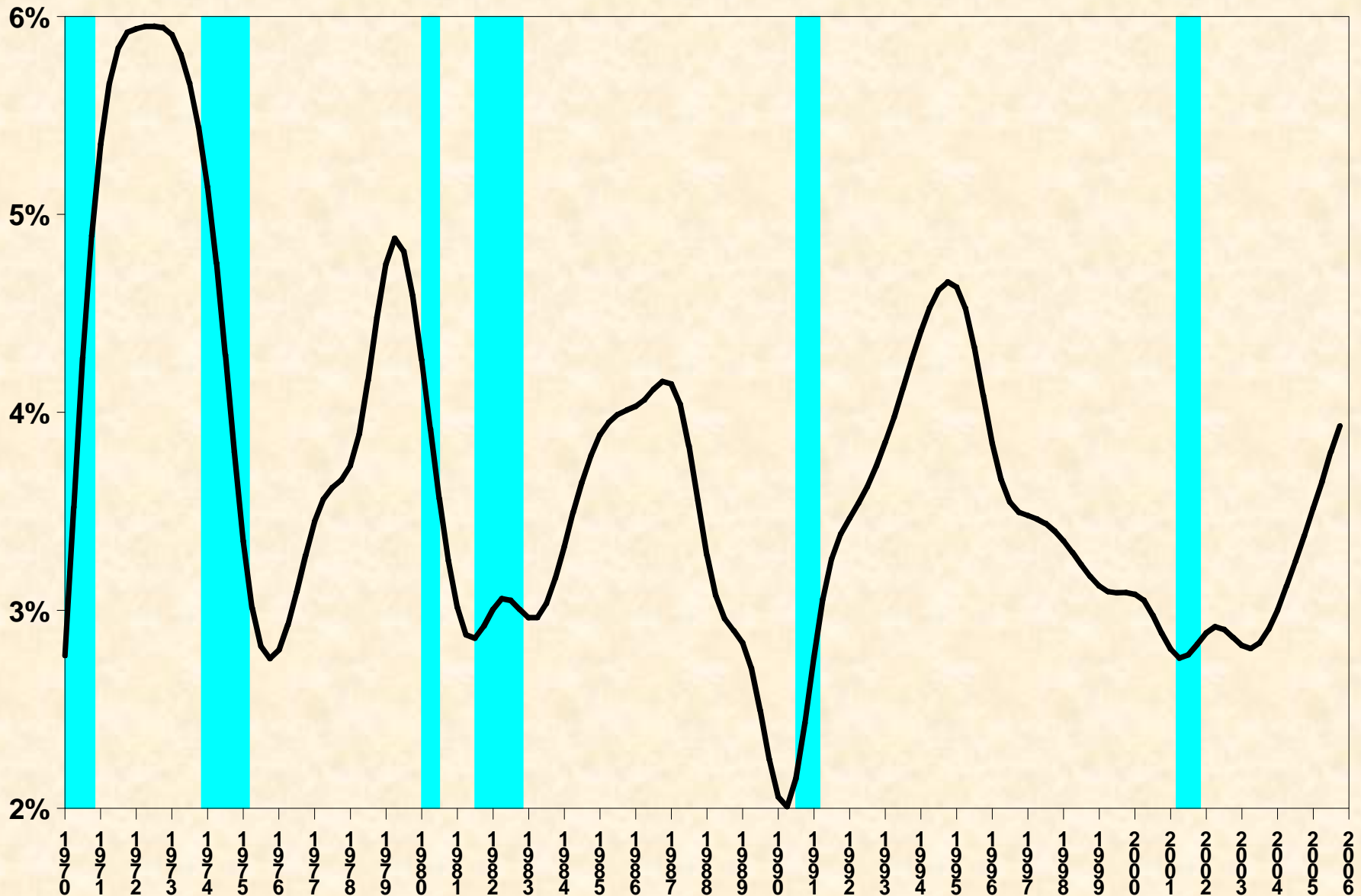
# Arizona Population Growth



History: ASU Center for Business Research (percent change)

Forecasts are from the January Bank One Arizona Blue Chip Economic Forecast

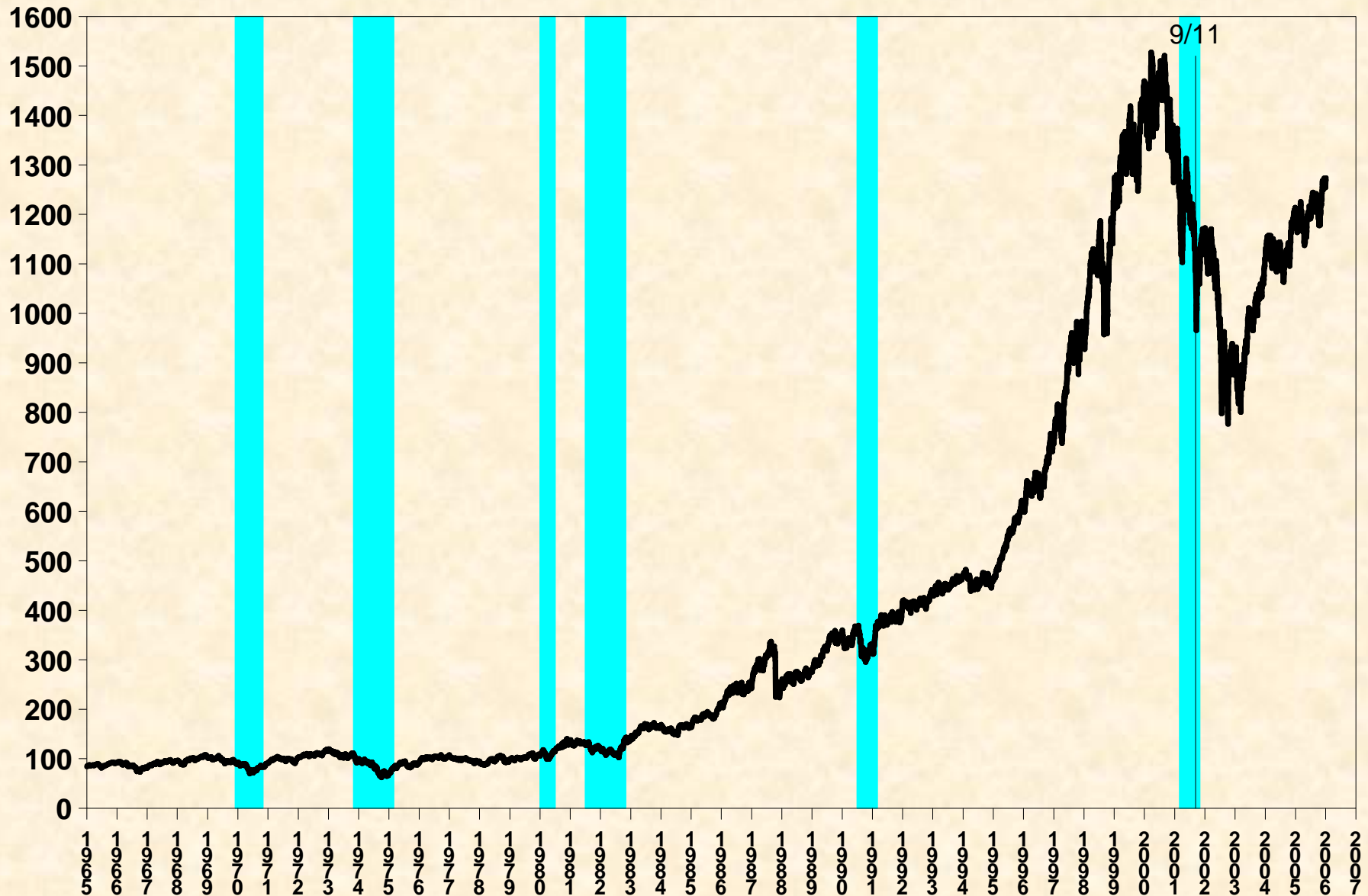
# Quarterly Arizona Population Growth 1970 to 2005



Source: ASU Center for Business Research (last data point Q4 2005= 3.8% )



# S&P 500 Composite Stock Price Index 1965 to 2006



Source: Daily Press (last data point 01/05/06 = 1273)

## Arizona Net Capital Gains 1988-2003

