

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.