

STATE OF ARIZONA

Joint Legislative Budget Committee

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FINANCE ADVISORY COMMITTEE

December 14, 2004

Senate Hearing Room 1 - 9:30 a.m.

Members Present:

Dan Anderson, Board of Regents
Tracy Clark, ASU
Pete Ewen, APS, Pinnacle West
Georganna Meyer, DOR
Elliott Pollack, Elliott D. Pollack and Co.
Hank Reardon, Reardon Economics
Debra Roubik, VisionEcon
Marshall Vest, UofA
Don Wehbey, Dept. of Economic Security

Mr. Richard Stavneak, Director, JLBC Staff, opened the meeting at 9:35 a.m. and welcomed everyone to the Finance Advisory Committee (FAC) meeting.

Mr. Stavneak said JLBC Staff would be giving some perspective on where the economy is at this point. Mr. Pollack will give a presentation on the national economy and Tracy Clark will address the state economy.

Mr. Tim Everill, Mr. Hans Olofsson, Mr. Brian Cary, JLBC Staff, provided a slide presentation and handout with an overview of the major revenue categories. ([Click here to view handout](#))

Georganna Meyer said she wanted to expand on something Brian Cary said. The four big months for Corporate Taxes are September, December, April and June. By now we have a good feel for estimated payments coming in for this tax year because we have gotten the April, June, and September payments. We can expect December to probably run the same, which is huge with a big percentage growth. The problem is the April and June payments. Those are the estimated payments for tax year 2005 and how large, if any growth occurs at all, is anyone's guess.

Elliott Pollack gave a slide presentation and handout on the national economy. ([Click here to view handout](#)) He said there has not been much change since September. He said he expects the expansion to continue. In summary, there are mostly good times ahead in 2005: fiscal stimulus and monetary stimulus; real income is up; business is lean and mean; productivity growth remains strong to this point in the cycle; job growth is accelerating although slowly; the cheaper dollar means more exports; inflation is not a problem in the near term; and interest rates, by historic standards, remain incredibly low.

Brian Cary asked as a follow-up question about the decline of the dollar versus the Euro, and if there are more alternatives now to global industries than in previous cycles that might make that more likely.

Elliott Pollack said there are lots of alternatives now with the strength in Asia.

Tracy Clark said that oil prices have come down, but believes they will not go down much more, and may even go up. The short-term shock to the economy is over. In sociological terms there is a marked lack of commitment or a fear of commitment by U.S. businesses because they are uncertain. They do not have to hire a lot of people yet because of productivity gains. Benefits costs are high and businesses do not know if the increases in demand are permanent, consequently they are not hiring. He said he does believe we will continue to see the economy expand.

He said he would go over briefly where we are year-to-date versus the forecast in the Blue Chip. In terms of retail, we are about 8.7% so far year-to-date. The forecast for 2004 from the panel is 7.2%, and for 2005 is 7.0%. If you limit yourself just to department stores and what most people consider when holiday buying, it is probably going to be an a good season. The luxury goods market is doing very well. What is going to make it better for the panel's purpose is that for a little while longer auto sales are going to stay strong. Retail sales should stay pretty good. Employment numbers year-to-date are at 2.3%, the panel expects us to be at 3.1% for 2004 and 3.8% for 2005. He does not think there is any way to get to 3.1%. There is no way that the revisions to the data will be large enough to get to 3.1%. The employment growth is coming from specialty trade contractors, furniture and home furnishing retailers, electronics and appliance retailers, building materials and garden supplies, management of companies and a lot of growth in healthcare. It is in things that have to do with population growth and our fears. Employment is worrisome, single-family construction permits are up 28.8% for the state. The majority of impact is going to be from investors. They are going to leave the market for one of two reasons. Either interest rates go up enough that it is no longer an economically feasible proposition to invest in real estate, or they get a better deal somewhere else. Mortgage rates are probably not going to go up enough to force people who actually want to live in the houses out of the market. It is enough to force investors out of the market. He said he couldn't give exact numbers on how much of the market is made up of investors. It is significant, but where investors are even more significant is they are driving up a lot of the housing appreciation. Investors are bidding up the housing prices. One of the risk points for the revenue maybe some fallback in construction. Maybe 3% to 5% down. Personal income growth is good.

The meeting adjourned at 11:04 a.m.

Cheryl Kestner, Secretary

Tim Everill, Revenue Section Chief

NOTE: A full tape recording of this meeting is on file in the JLB Staff office at 1716 West Adams.

Finance Advisory Committee

December 14, 2004

JLBC

FY 2005 Revenue Collections

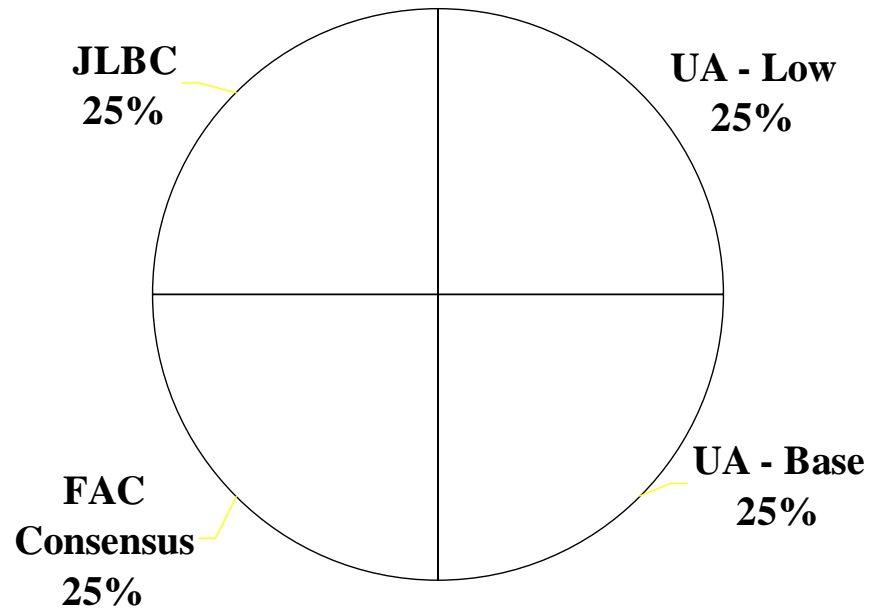
Strong Year-to-Date Performance

- Through October, revenue collections are \$140 million over the budgeted forecast.
- Collections for the first 4 months are over 15% above last year.
- Preliminary November numbers show trend continuing.
- Big 3 categories all show strong increases.

FAC Forecast is a Component of JLBC Staff's "Big 3" General Fund Revenue Consensus Estimate

Big 3 forecast equally weights:

- **FAC average**
- **UofA model - base**
- **UofA model - low**
- **JLBC staff forecast**
- **Remaining revenues (6% of total) are staff forecast**

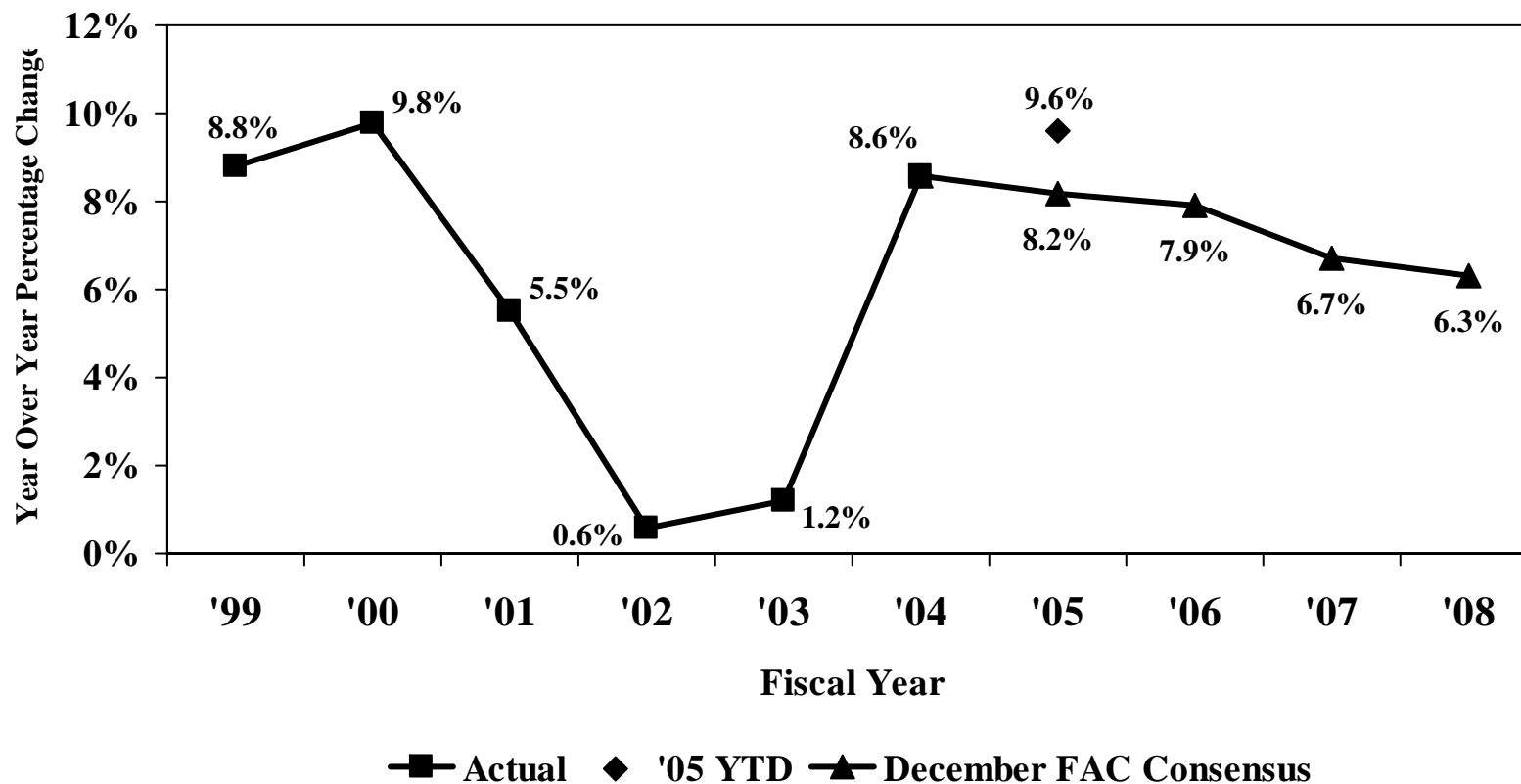


In FY 04, these 3 revenues grew by 10.4%. The UofA base model, which forecasted 7.8% growth, came closest to predicting actual growth. FAC panel forecast of 7.3% was slightly lower.

Sales Tax Growth Rate

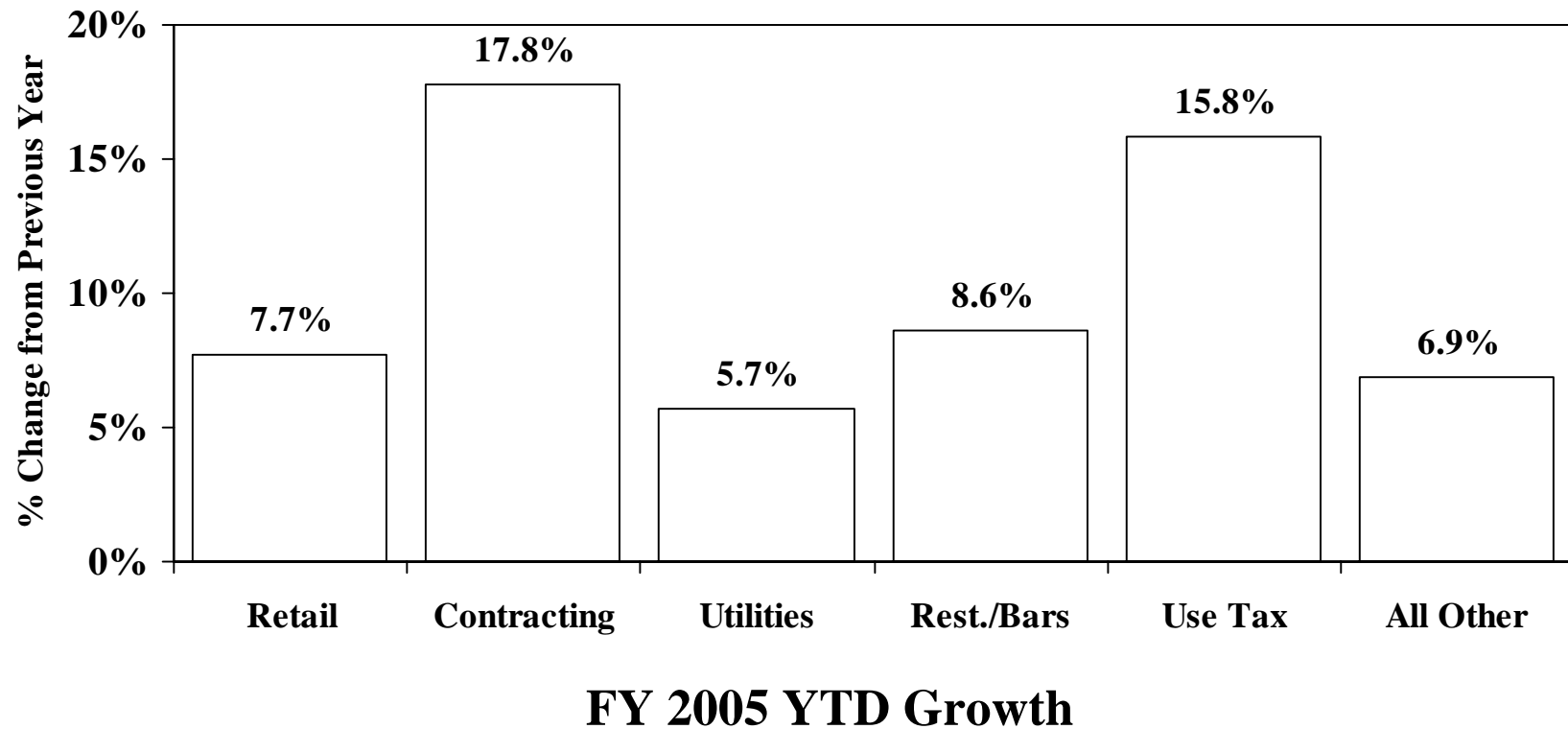
Gained Momentum in Recent Months

FAC Panel Below YTD Collections



FY 2004 Actual = \$3.3 Billion

Sales Tax Collections are Robust In Most Categories



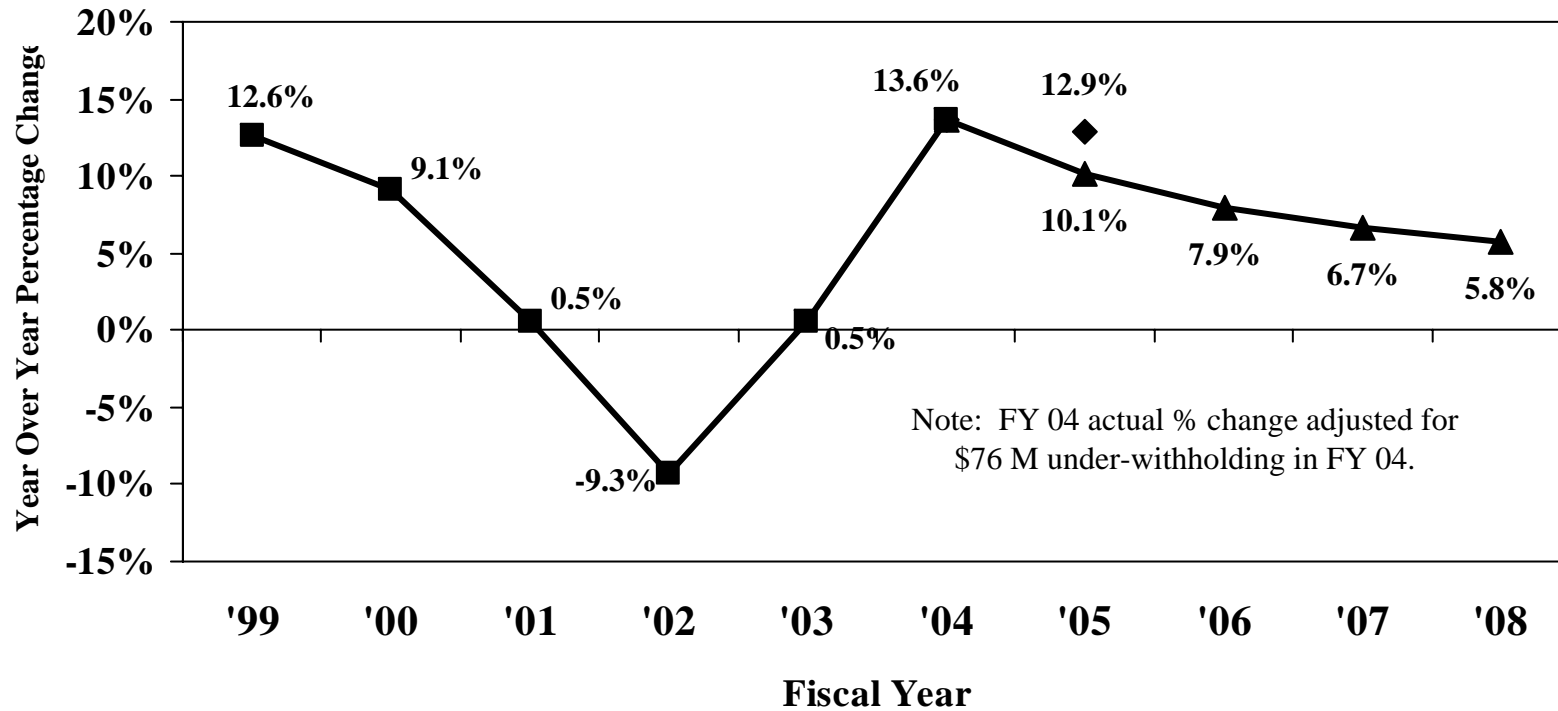
Sales Tax Questions for the FAC Panel

- How long will the contracting boom continue?
- What are your expectations for the current holiday buying season relative to recent years?
- Will inflation or the decline of the dollar's value in foreign exchange markets lead to higher long-term interest rates?
- What is your outlook for Arizona's tourism industry?

Individual Income Tax Growth Rate

Continued Strong Collections

FAC Panel Slightly Below YTD Collections



—■— Actual ◆ '05 YTD —▲— December FAC Consensus

FY 2004 Actual = \$2.3 Billion

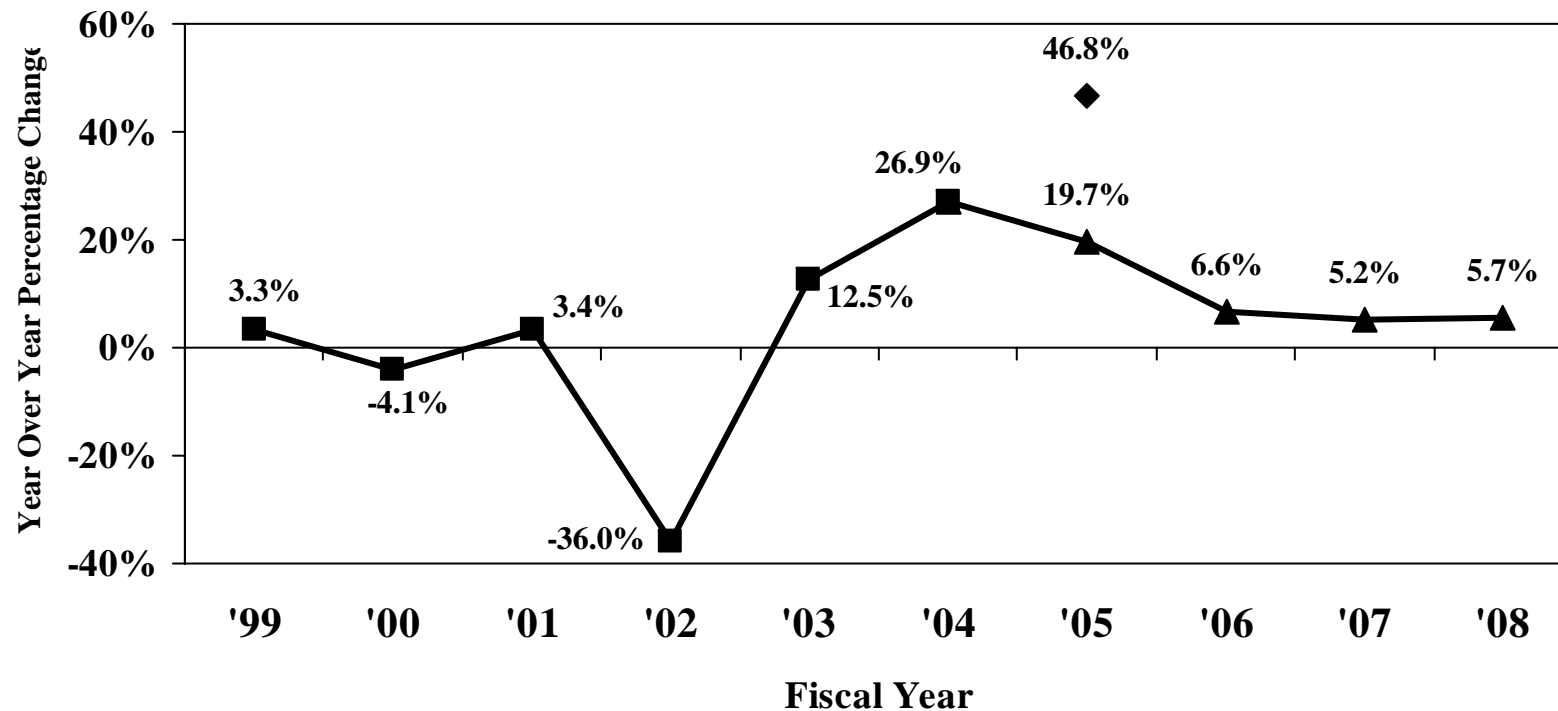
Performance of Categories Other Than Withholding Is Critical to the Forecast

- Estimated Payments – 3 out of 4 quarterly payments remain to be collected this fiscal year.
- Estimated Payments – Primarily based on non-wage earnings and is therefore a volatile revenue source.
- Final Payments and Refunds – 90% of these individual income tax components determined in the next 7 months.

Corporate Income Tax Growth Rate

Continues to Accelerate

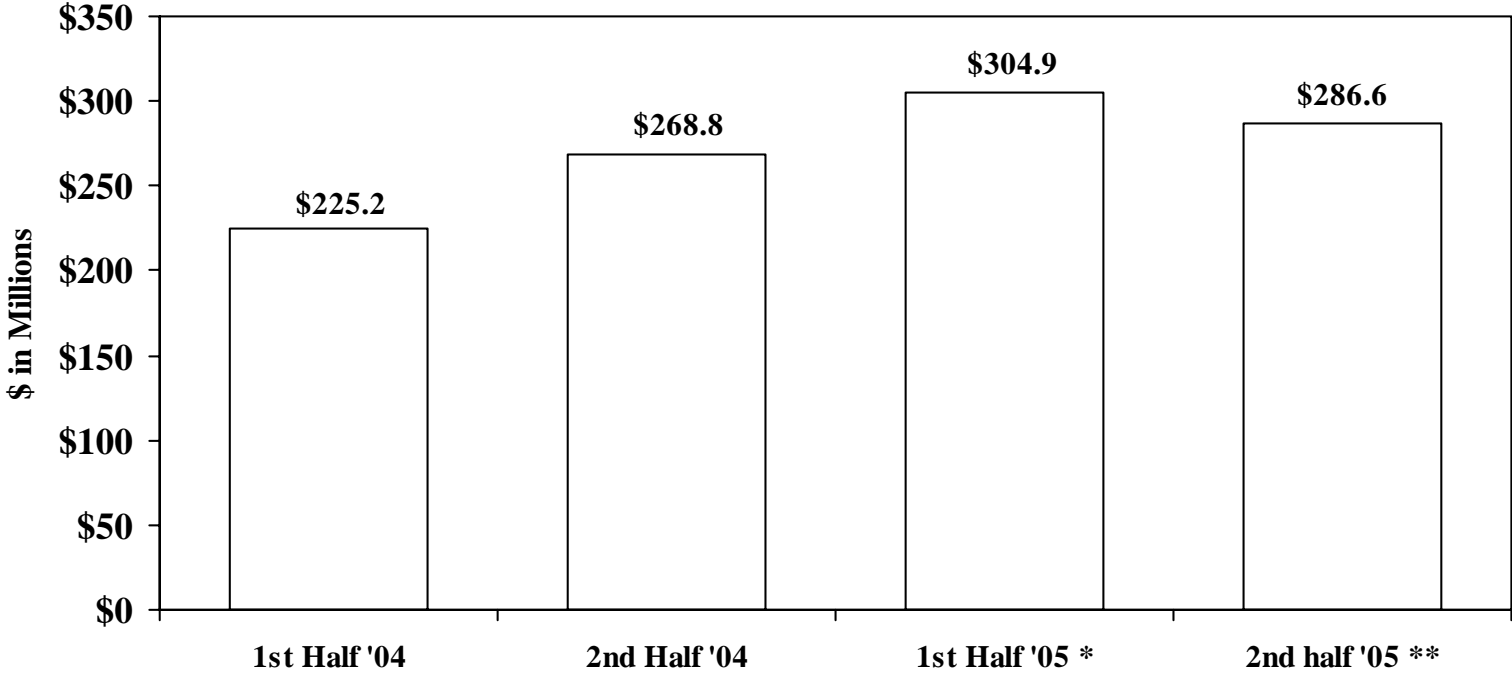
FAC Panel Sees Slowdown of Growth Rate by Year-End



—■— Actual ◆ '05 YTD —▲— December FAC Consensus

FY 2004 Actual = \$0.5 Billion

Corporate Income Tax Collections



* Includes 5 months actual collections and estimate for December.

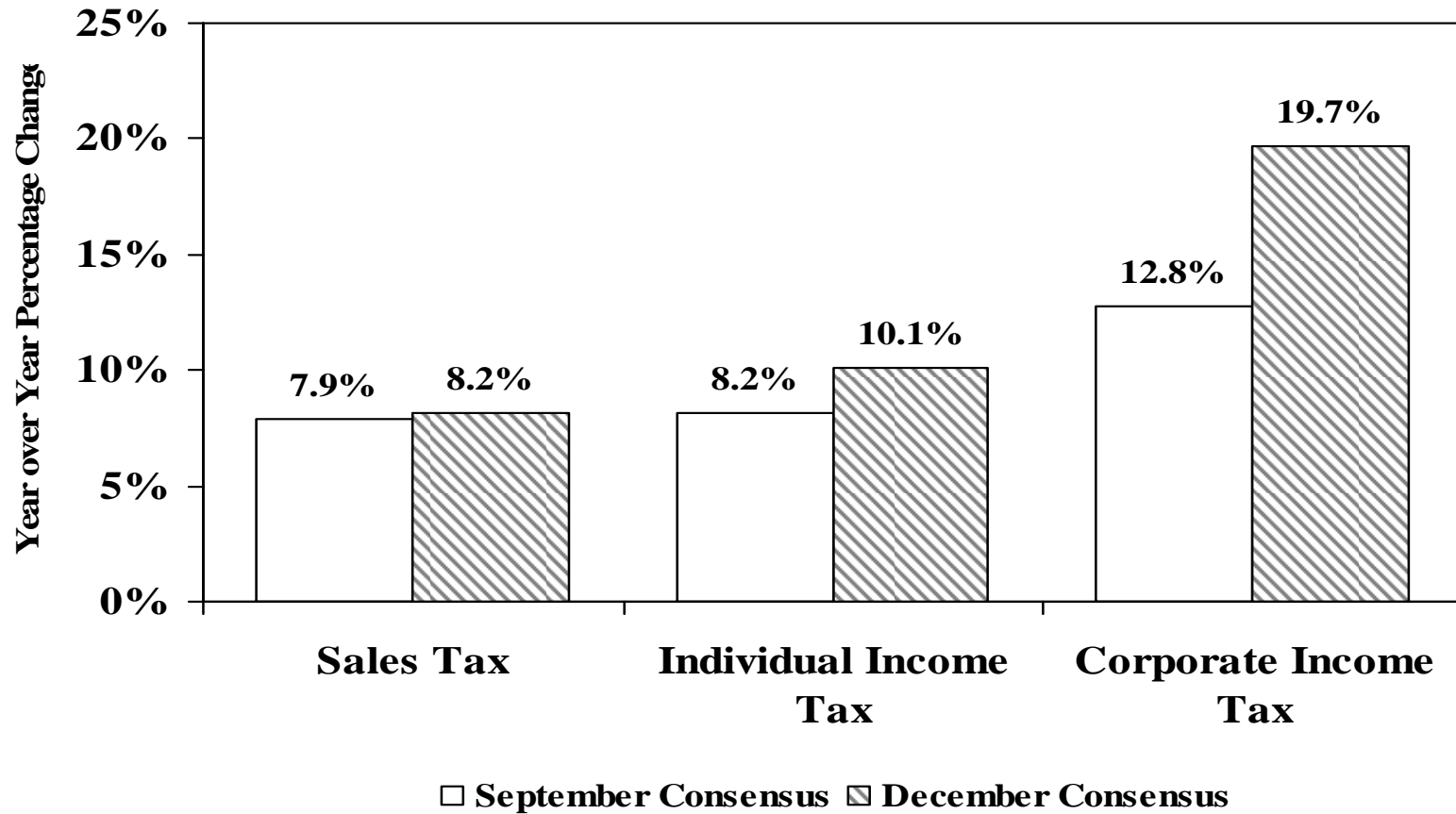
** Based on FAC panel consensus forecast.

Critical Issues for Corporate Income Tax Revenue

- While corporate collections are growing rapidly, tax refunds are running far below the levels reported in recent years .
- Many large corporations have warned the financial markets that profits may fall short of expectations in the months ahead. After rising by an estimated 15.0% in 2004, the U.S. Blue Chip forecast panel predicts corporate profits will increase by 9.7% in 2005.

FY 2005 Growth Rates

FAC Panel – December Consensus More Optimistic Than September



The Slippery Slope Upward

Elliott D. Pollack & Company

FAC

December 14th, 2004

Warning: Economic Forecast



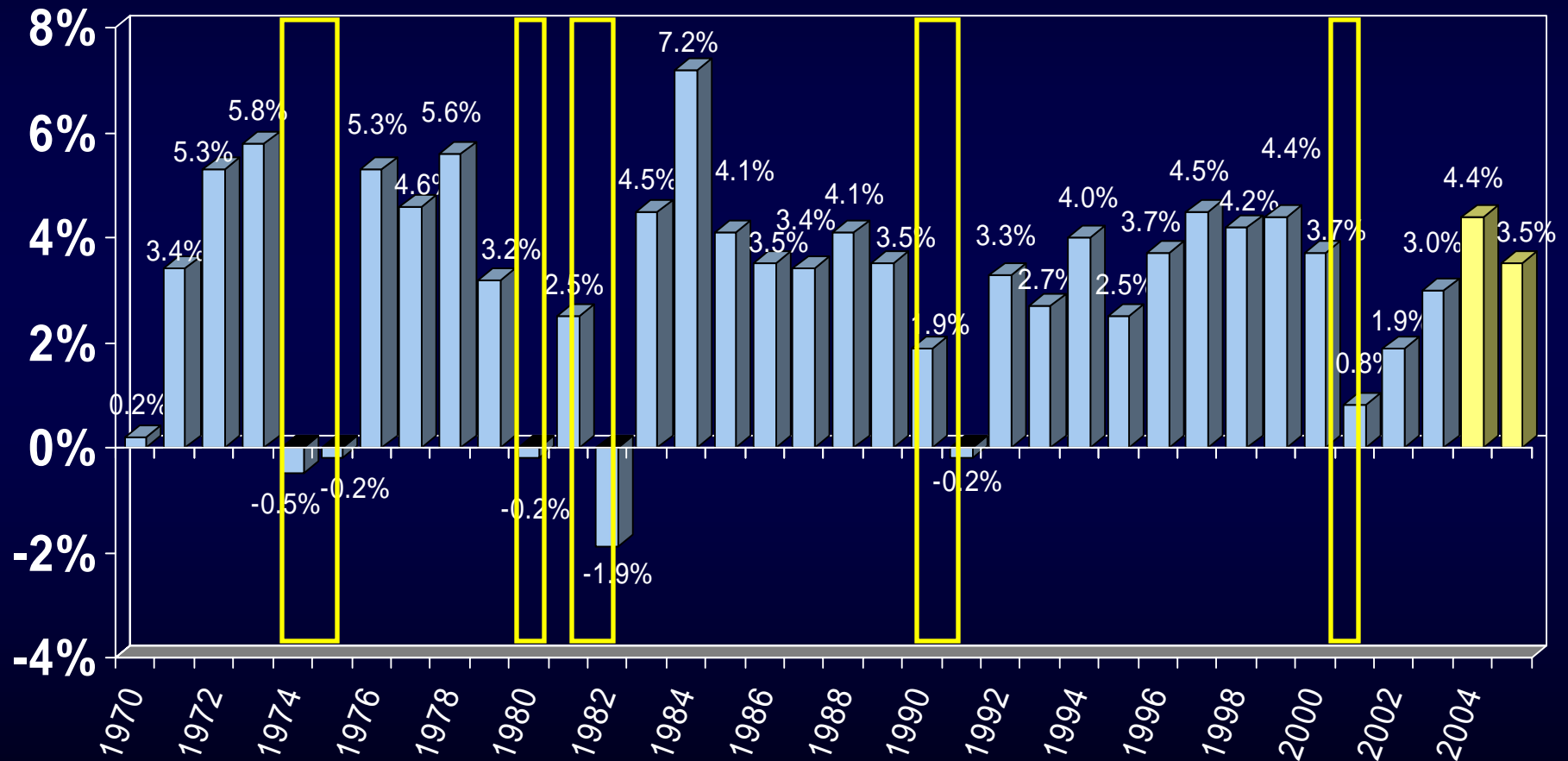
U. S Economy: Is the Glass Half Full?

- **Solid GDP Growth**
- **Low inflation rates**
- **Low Unemployment**
- **Stock Market?**
- **Business Spending & Hiring?**



United States Real Gross Domestic Product* Annual Growth 1970 - 2005**

Source: U.S. Bureau of Economic Analysis & *Blue Chip Economic Indicators*



* Based on chained 2000 dollars.

** 2004 - 2005 are forecasts from the Blue Chip Economic Indicators, Dec 2004

Recession Periods

U.S. Blue Chip Forecasts

Gross Domestic Product

<u>Month</u>	<u>2004</u>	<u>2005</u>
April	4.6%	3.8%
May	4.6%	3.8%
June	4.7%	3.7%
July	4.5%	3.8%
August	4.4%	3.7%
September	4.3%	3.6%
October	4.4%	3.5%
November	4.4%	3.5%
December	4.4%	3.5%



**The
economy
is still
strong.**

**Any slowdown
is likely to be
transitory**

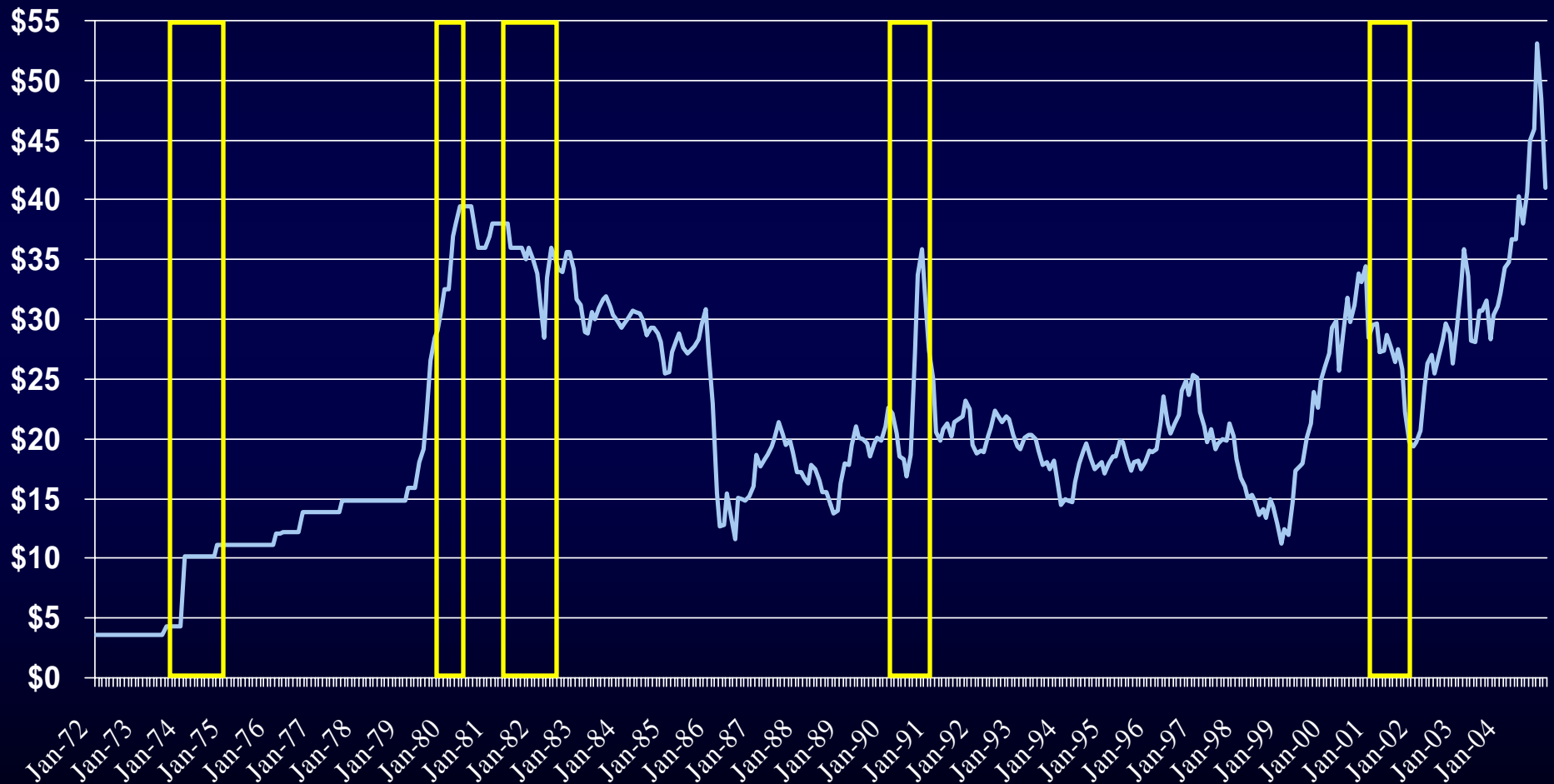


Oil



Oil Prices 1972 – 2004*

Source: Federal Reserve Board of St. Louis



•Data through December 10, 2004

□ Recession Periods

IMPACTS

- **Cuts into consumer spending.**
- **Squeezes corporate profits and leads to less hiring and spending.**
- **Price effects → CPI → Bond prices**

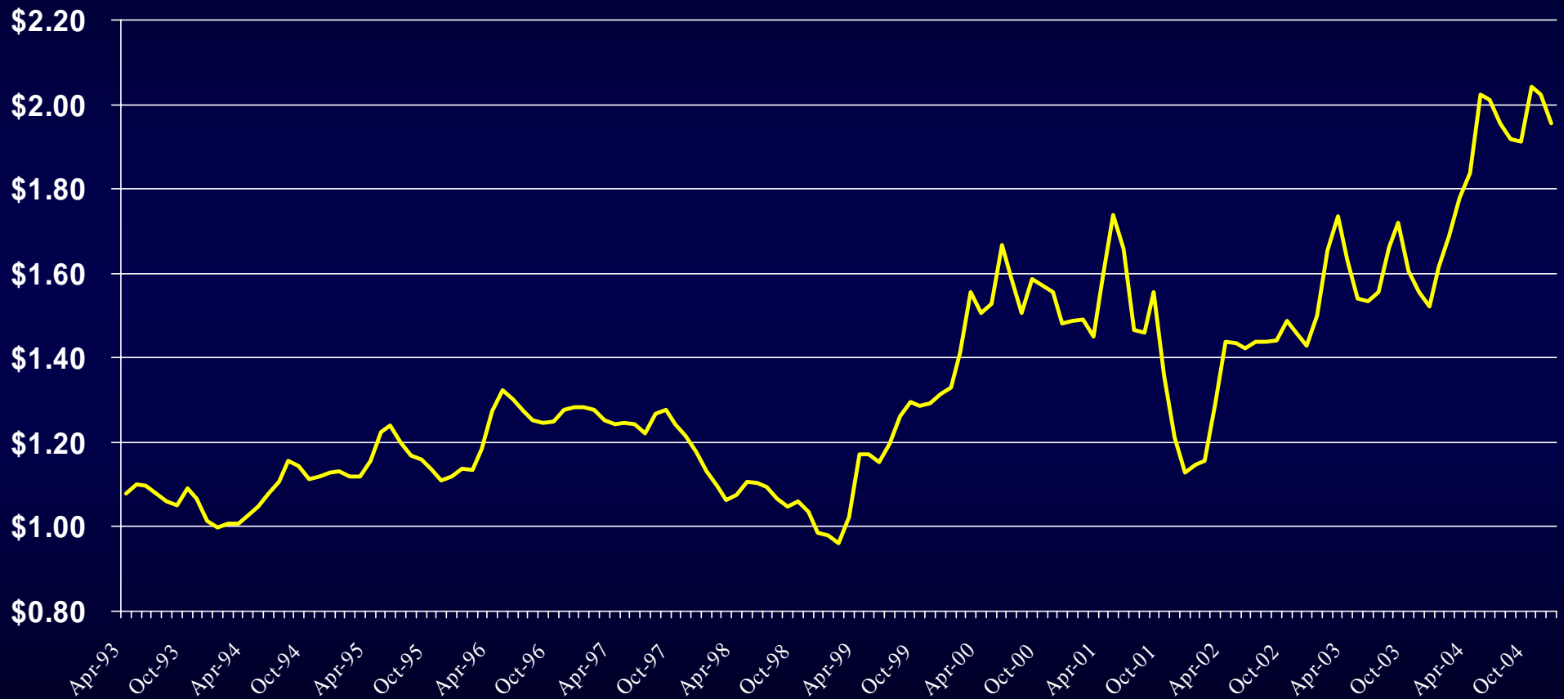
IMPACT ON JOBS

Because labor is a major variable cost, higher energy outlays add more pressure to control labor costs.

**So far, little price or
bond effect.**

U.S. Motor Gasoline Prices 1993 – 2004*

Source: Energy Information Administration



* Data through December 6, 2004.

Future of oil prices is uncertain.



**But shocks
could
occur that
would
make the
expansion
bumpy.**

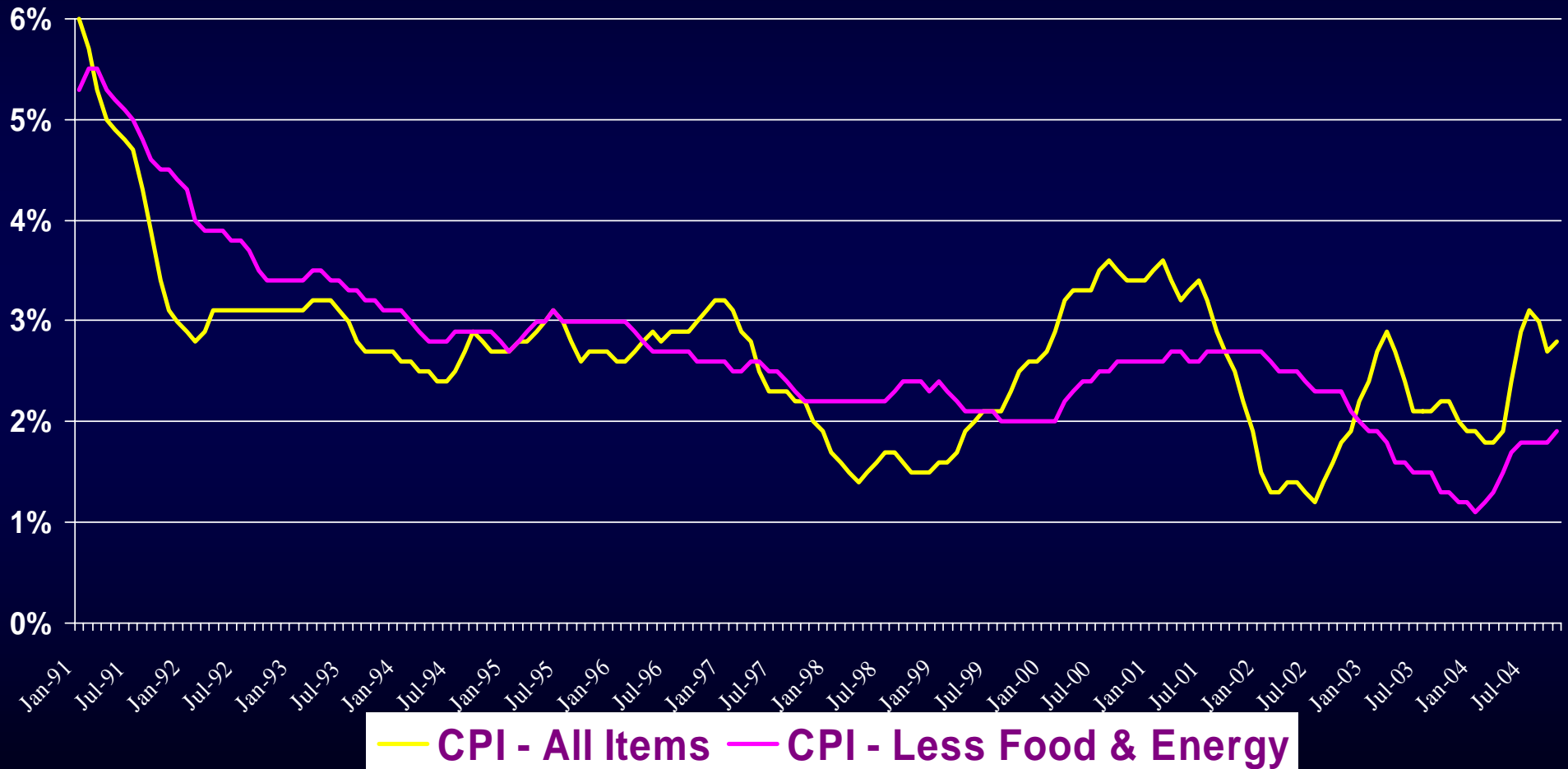


Consumer



Consumer Price Index Percent Change Year Ago 1991 – 2004*

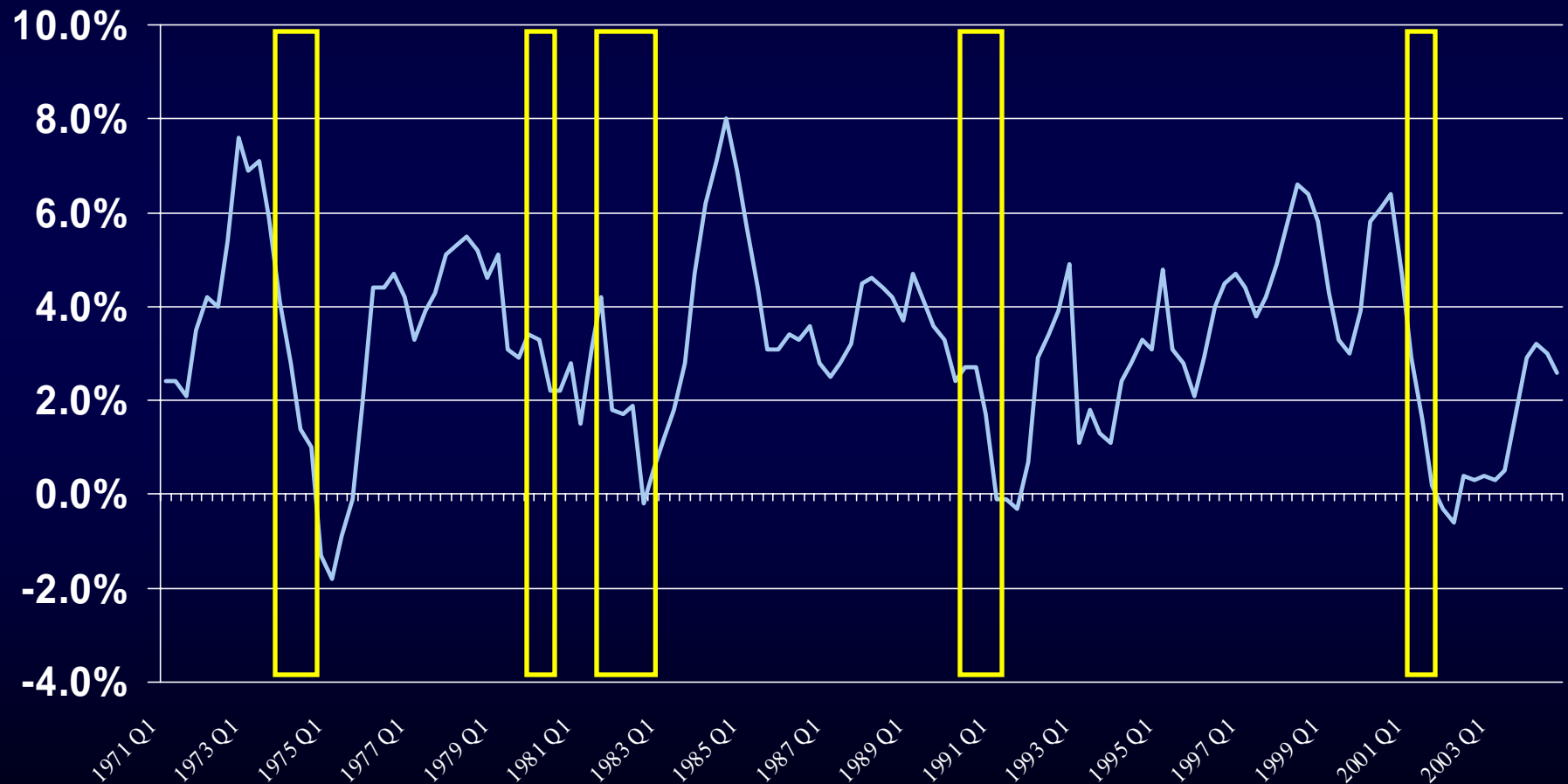
Source: Bureau of Labor Statistics



•Three-month moving average. Data through October 2004.

U.S. Real Personal Income Percent Change Year Ago 1971 – 2004*

Source: Bureau of Economic Analysis

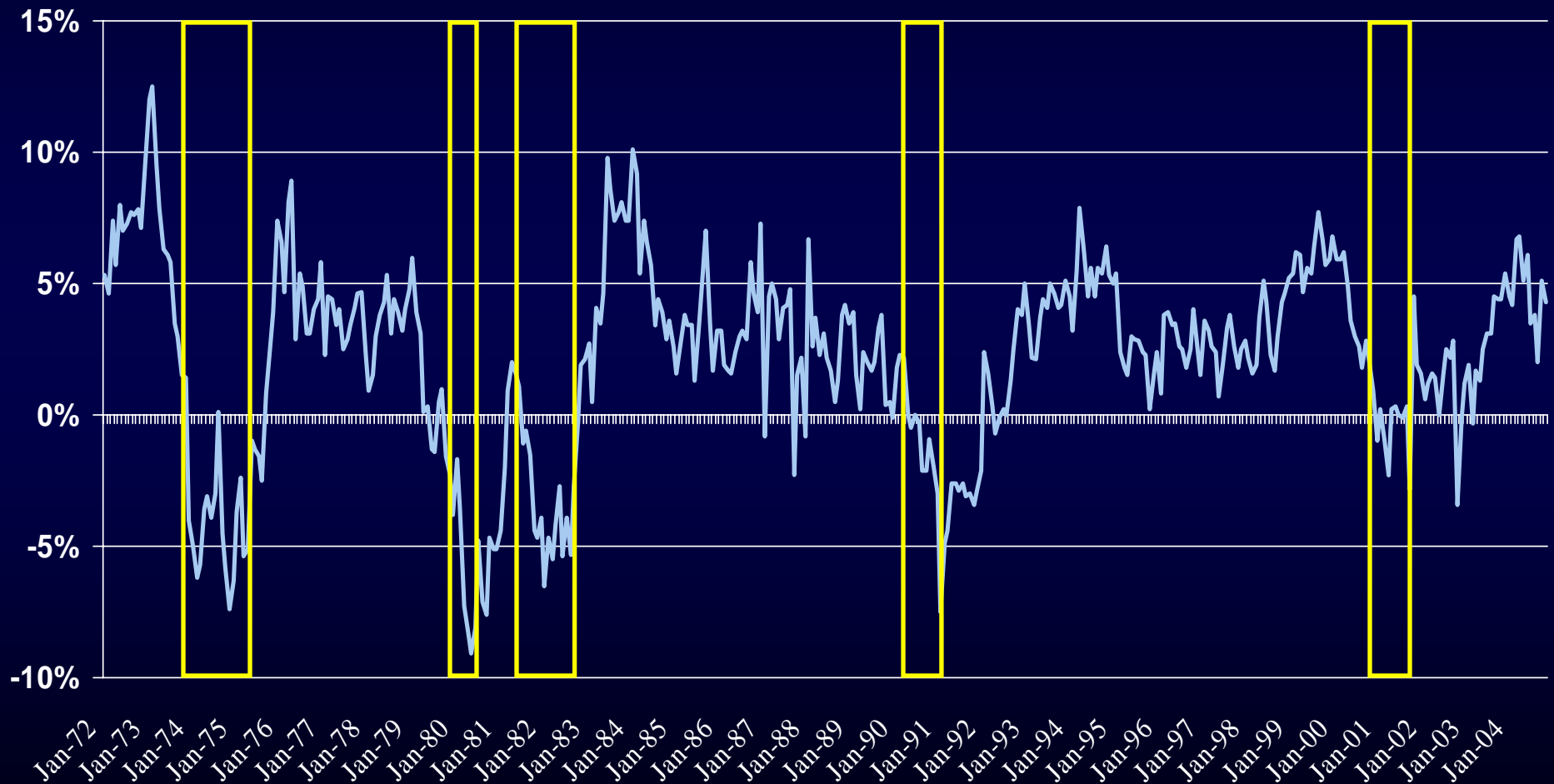


*Data through third quarter 2004

 Recession Periods

U.S. Real Retail Sales 1972 – 2004*

Source: Federal Reserve Board of St. Louis

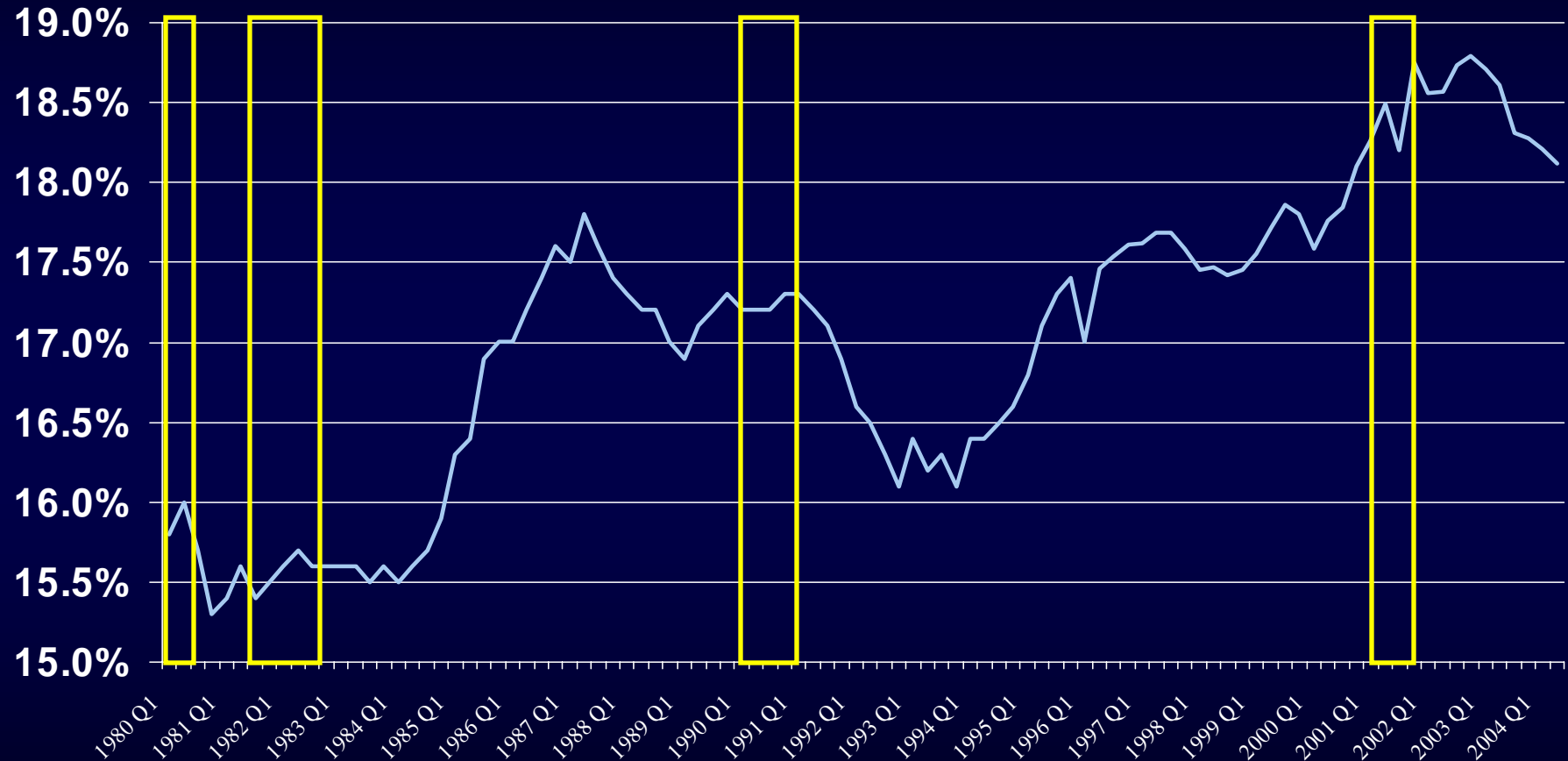


* Data through October 2004.

 Recession Periods

Financial Obligation Ratio 1980 – 2004*

Source: Board of Governors, Federal Reserve Board



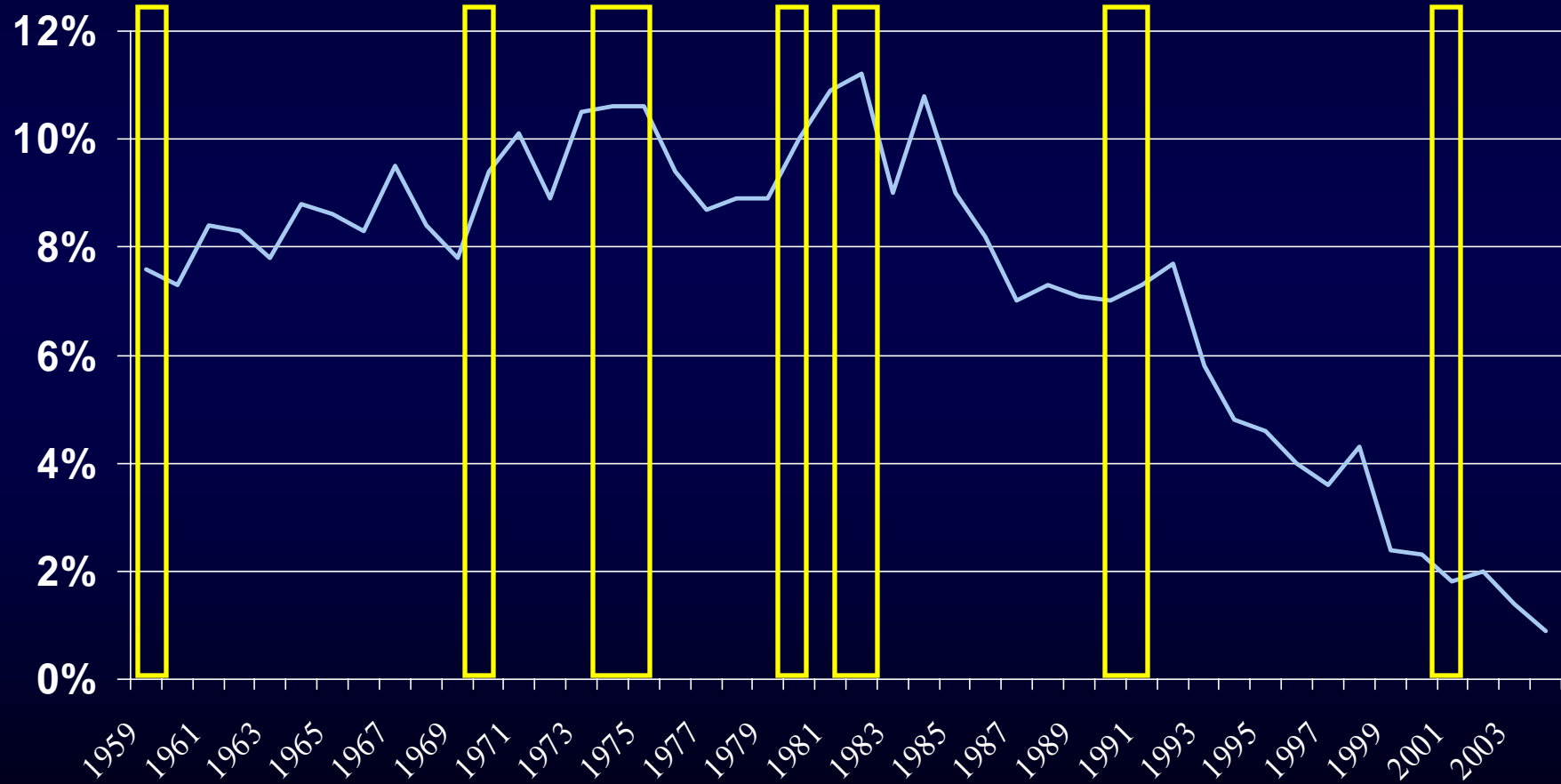
NOTE: The FOR includes debt service payments as a percent of disposable income. The FOR is a broader measure as it includes auto lease payments, rental payments, homeowner's insurance and property taxes.

*Data through second quarter 2004.

 Recession Periods

U.S. Personal Savings Rate 1959 – 2004*

Source: U.S. Bureau of Economic Analysis

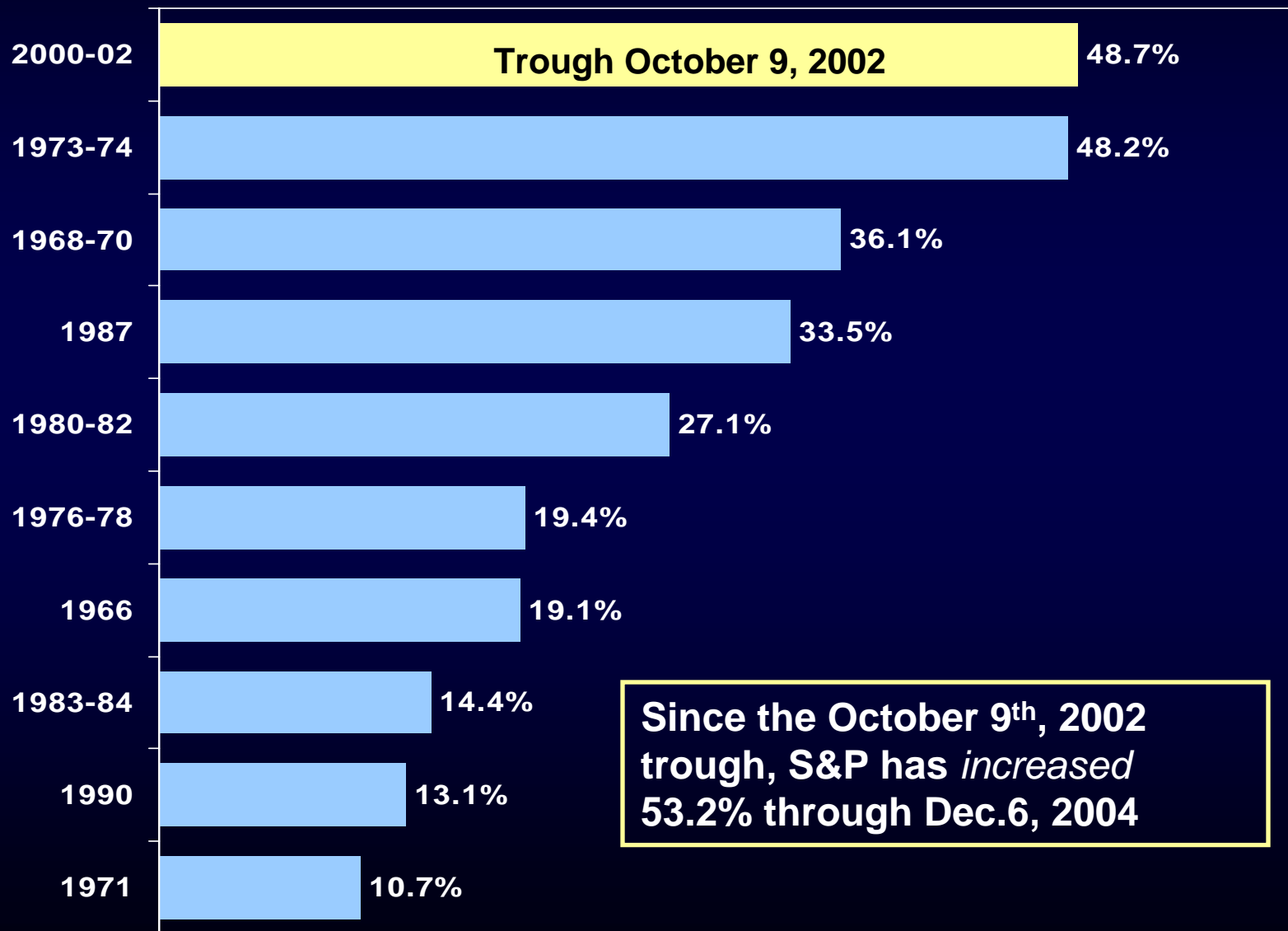


*Data through October 2004

Recession Periods

Bear Markets

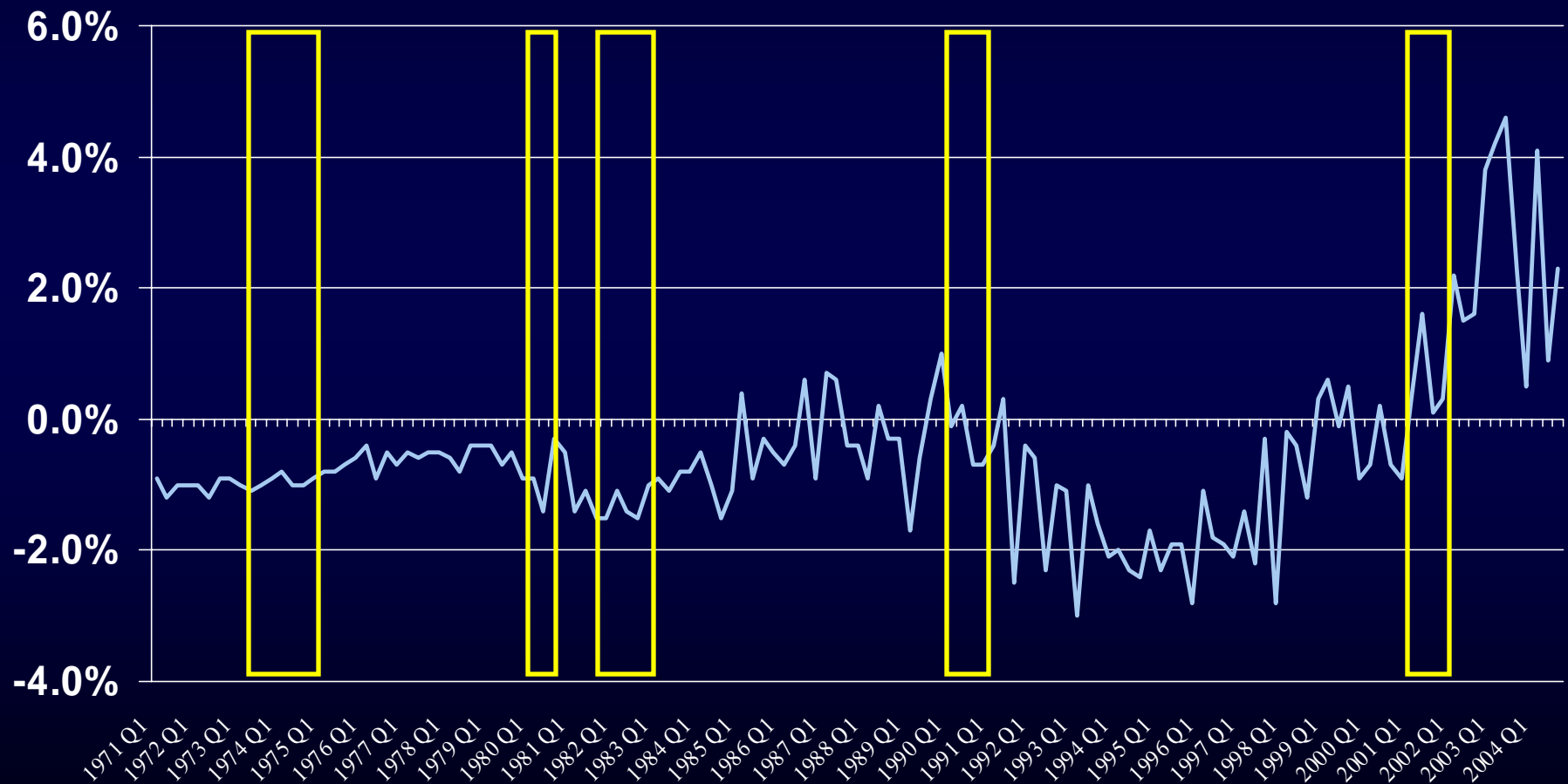
Ranking of Peak to Trough Declines S&P Composite Stock Price Index



Mortgage Equity Withdrawal as a share of Disposable Income

U.S.: 1971 – 2004*

Source: Bureau of Economic Analysis



* Data through third quarter 2004

 Recession Periods

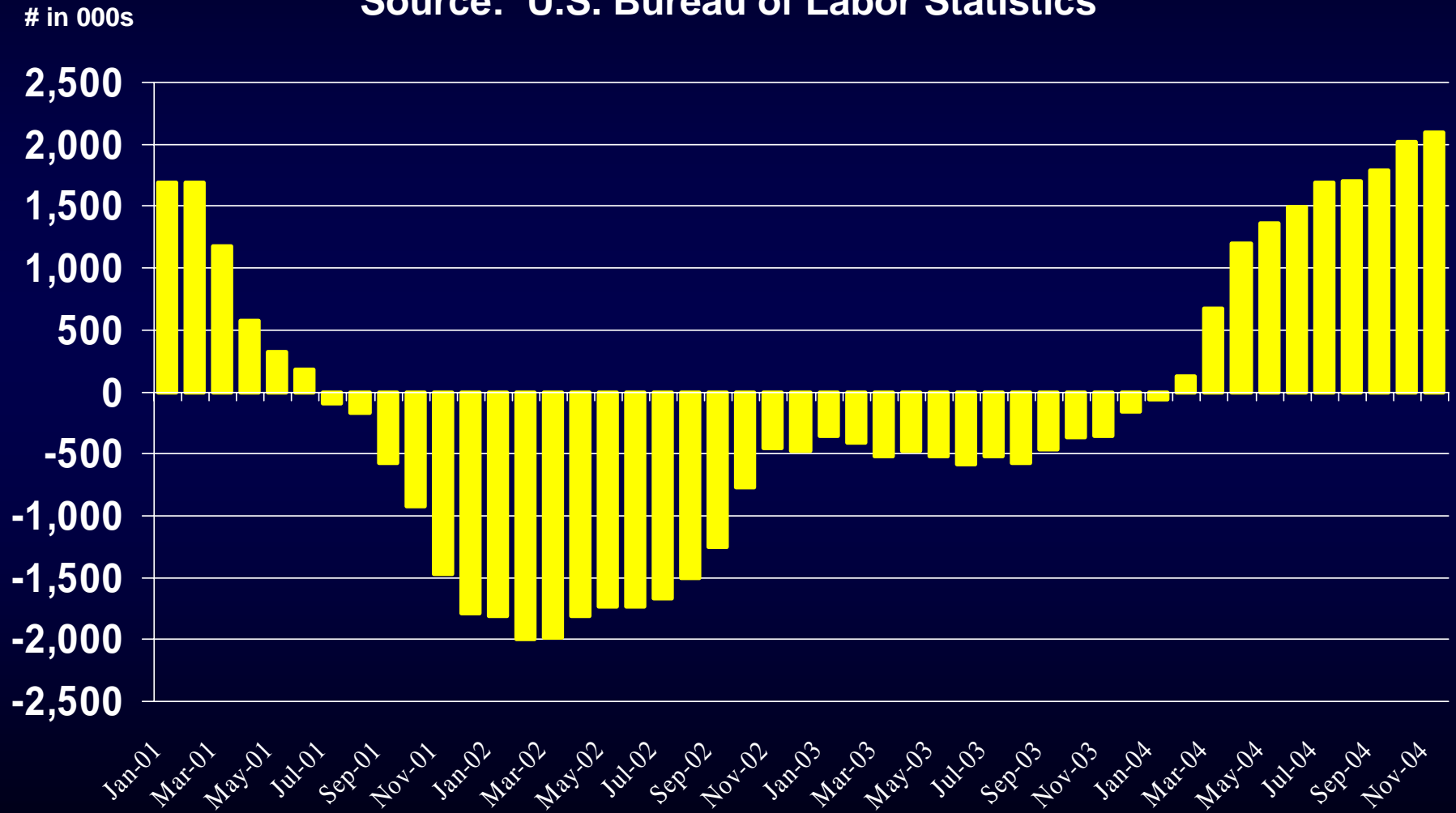
Unemployment Rate

Unemployment Rate 34 months Post Recession

<u>Recession</u>	<u>UER at End</u>	<u>UER 34 months post</u>
1975	8.5%	7.0%
1982	10.8%	7.1%
1991	6.8%	6.5%
2001	5.6%	5.4%

National Employment (Net change in jobs over year ago) January 2001 – November 2004

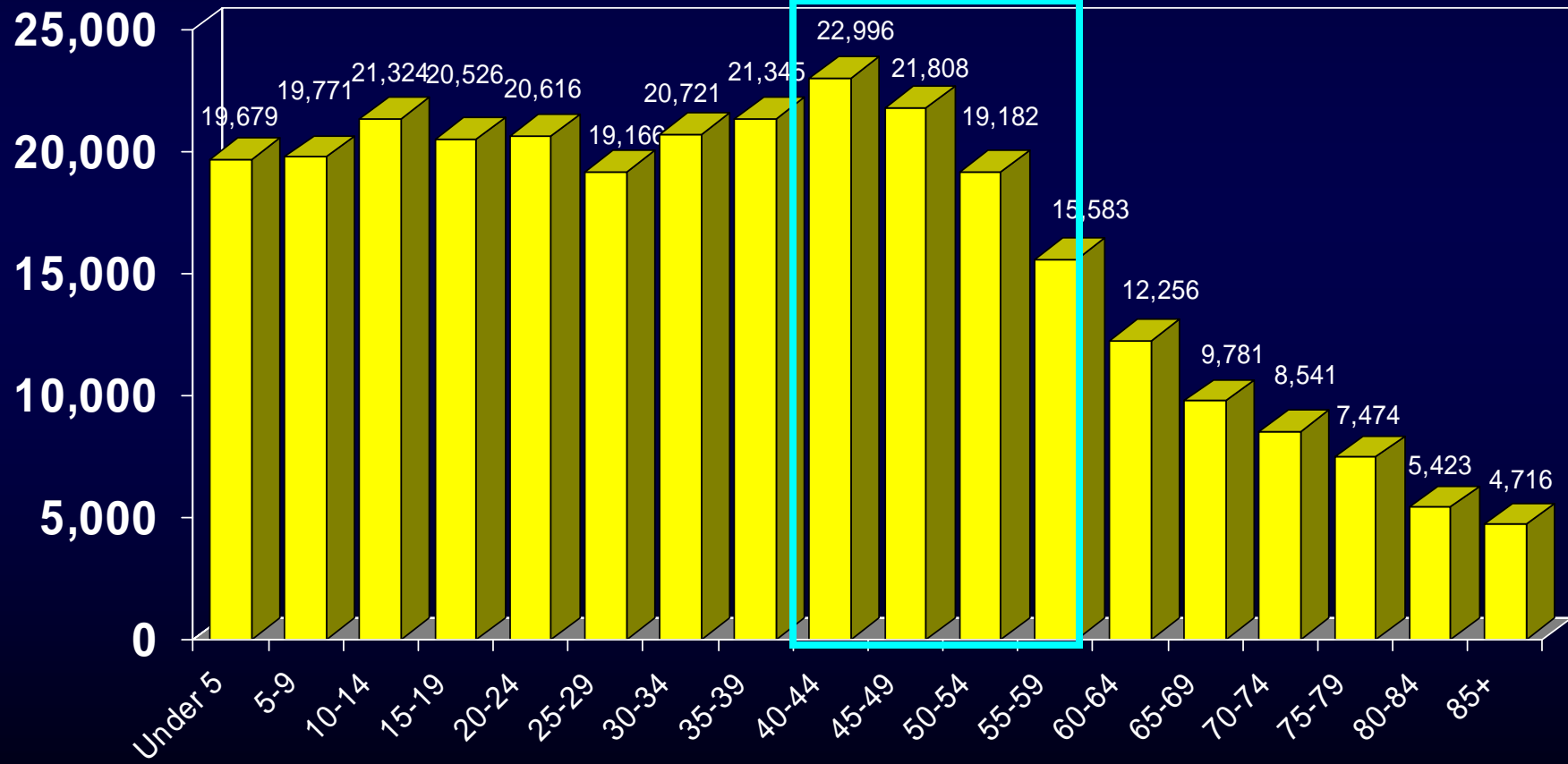
Source: U.S. Bureau of Labor Statistics




2003 U.S. Population by Age

Source: U.S. Bureau of the Census

Thousands



 Baby Boomers

Civilian Labor Force: Population Entering and Exiting the Labor Force

<u>Year</u>	<u>20-24 years</u>	<u>60-64 years</u>	<u>Difference</u>
1970	17,202	8,676	8,826
1980	21,386	10,143	11,243
1990	19,132	10,619	8,513
2000	19,140	10,867	8,273
2005	20,963	13,153	7,810
2010	21,995	16,638	5,357
2015	22,615	18,958	3,657
2020	21,859	21,186	673

Source: U.S. Census Bureau & Arizona Department of Economic Security

Business



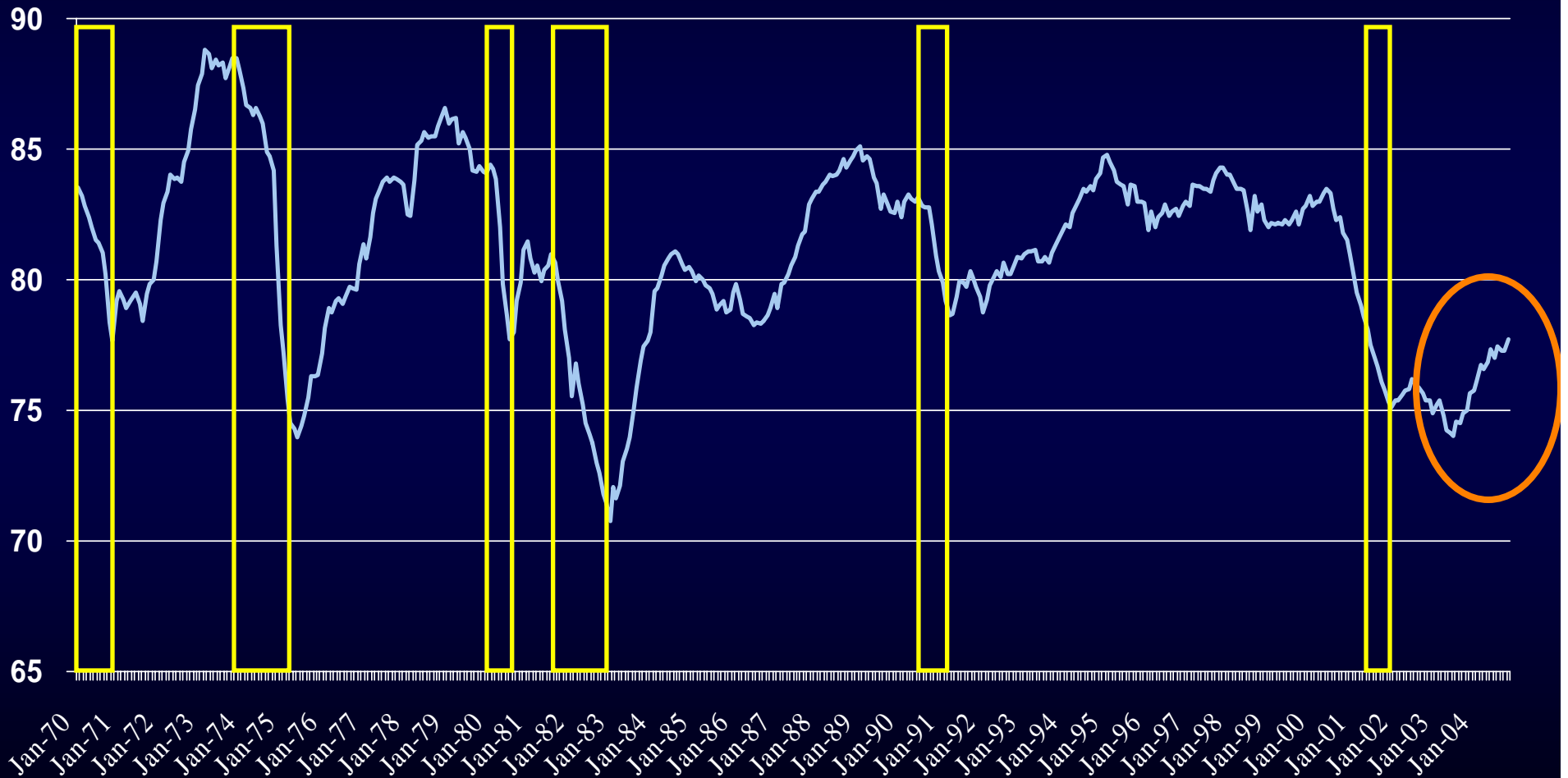
**You're
Fired!**

**Entering portion of
cycle where business
spending will drive
economy.**

**Businesses
playing things
close to the vest**

Capacity Utilization Rate 1970 – 2004*

Source: The Conference Board

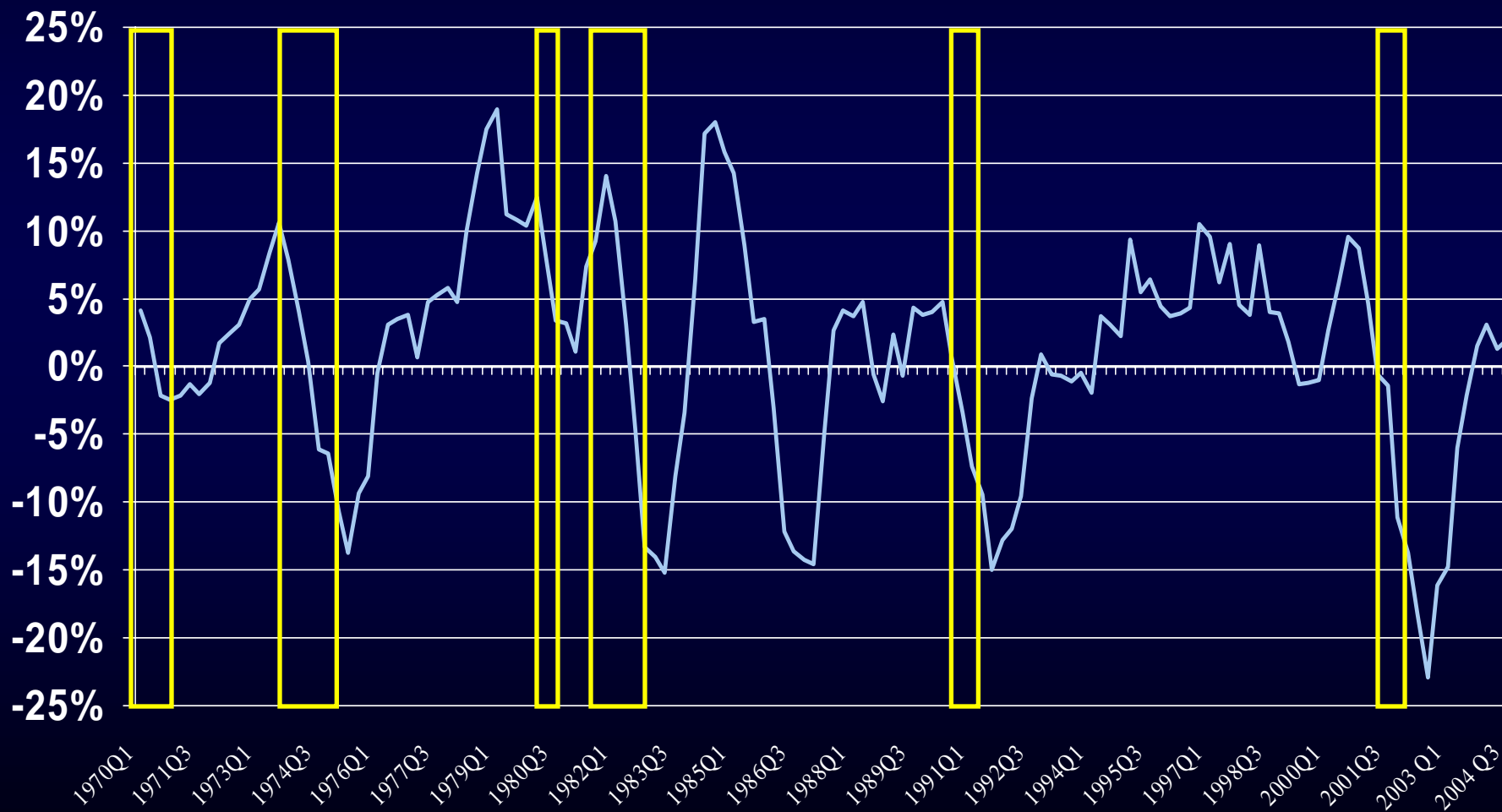


* Data through October 2004.

□ Recession Periods

Total Plant Spending Percent Change Year Ago (Real Dollars) 1970 – 2004*

Source: Bureau of Economic Analysis



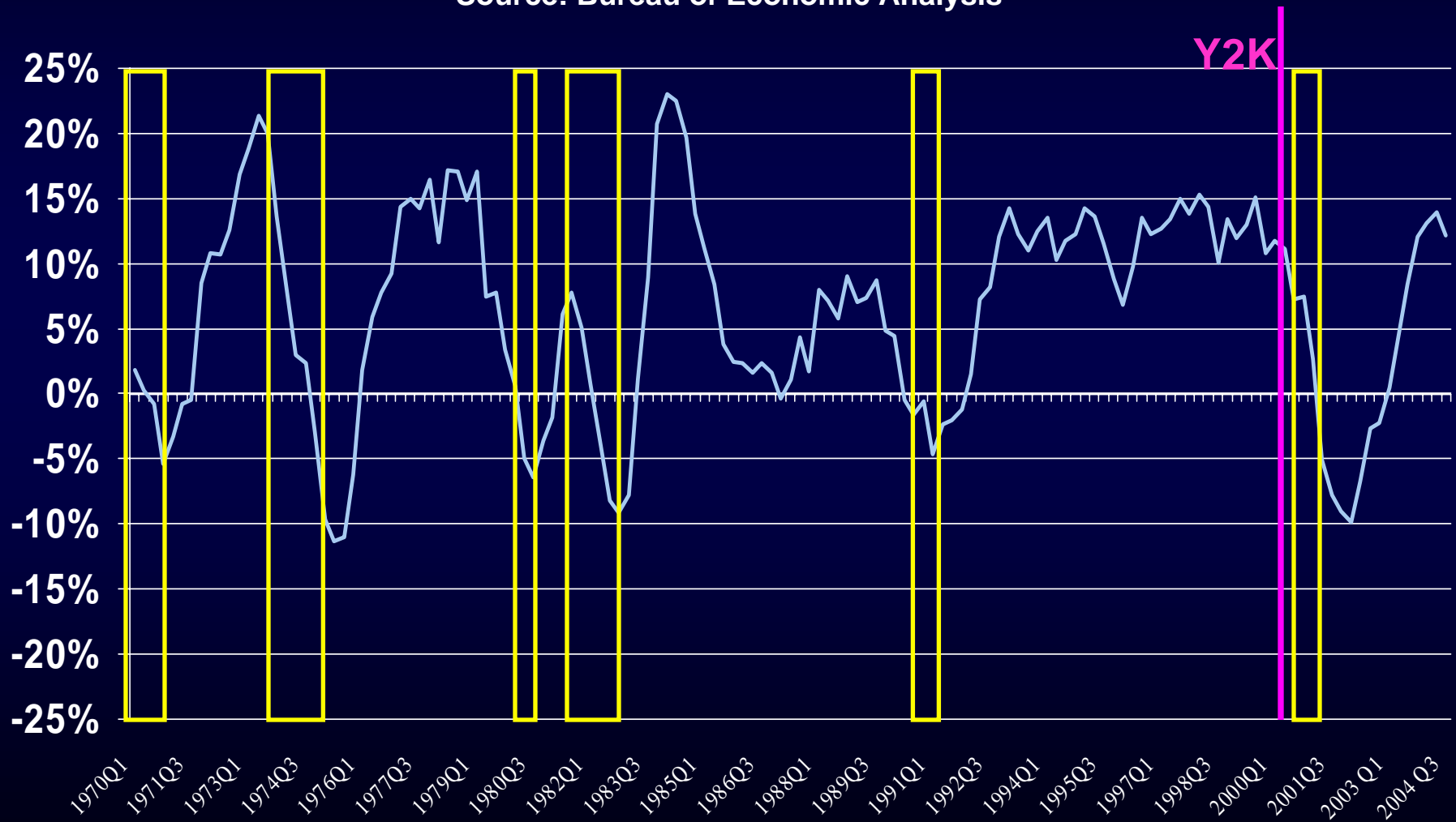
•Data through third quarter 2004.

•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 – 2004*

Source: Bureau of Economic Analysis



•Data through third quarter 2004.

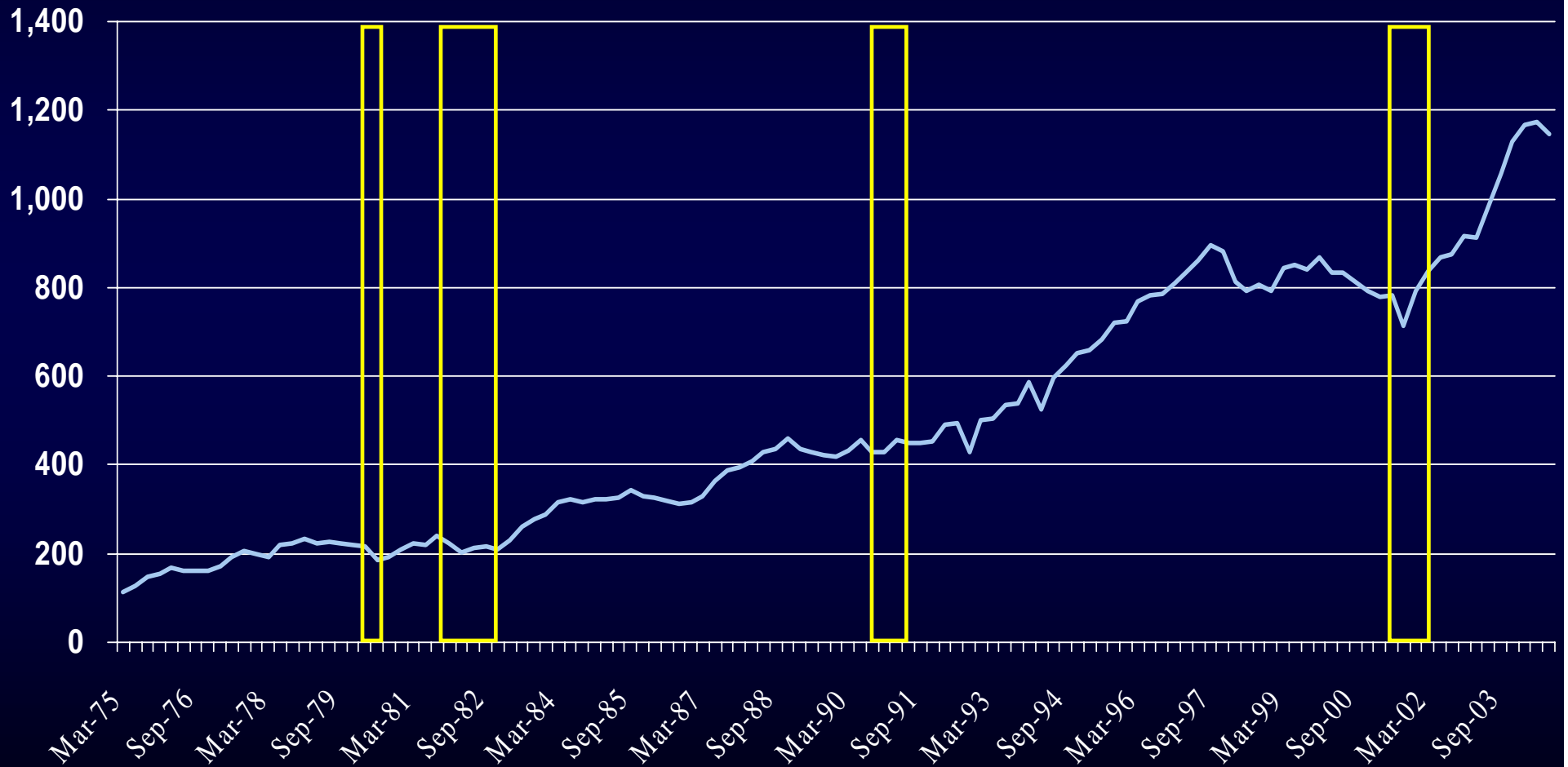
•NOTE: Series was revised in March 2004. Data prior to 1990 was not provided.

 **Recession Periods**

Corporate Profit 1975-2004*

(Billions of Dollars, SA)

Source: Freelunch.com



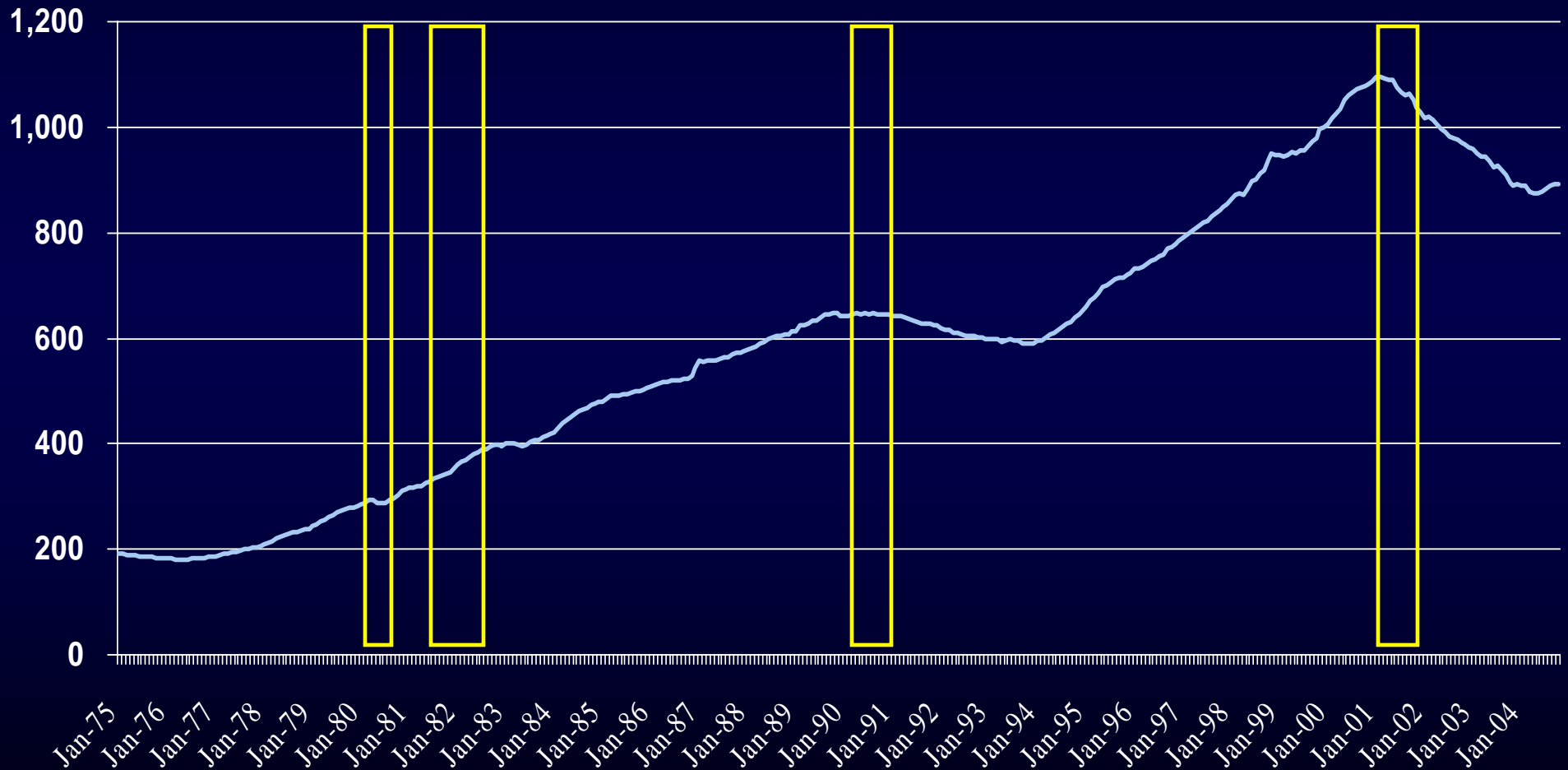
•Data through third quarter 2004

Recession Periods

Commercial & Industrial Loans, U.S. Based Banks 1975-2004*

(Billions of Dollars, SA)

Source: Federal Reserve Economic Database

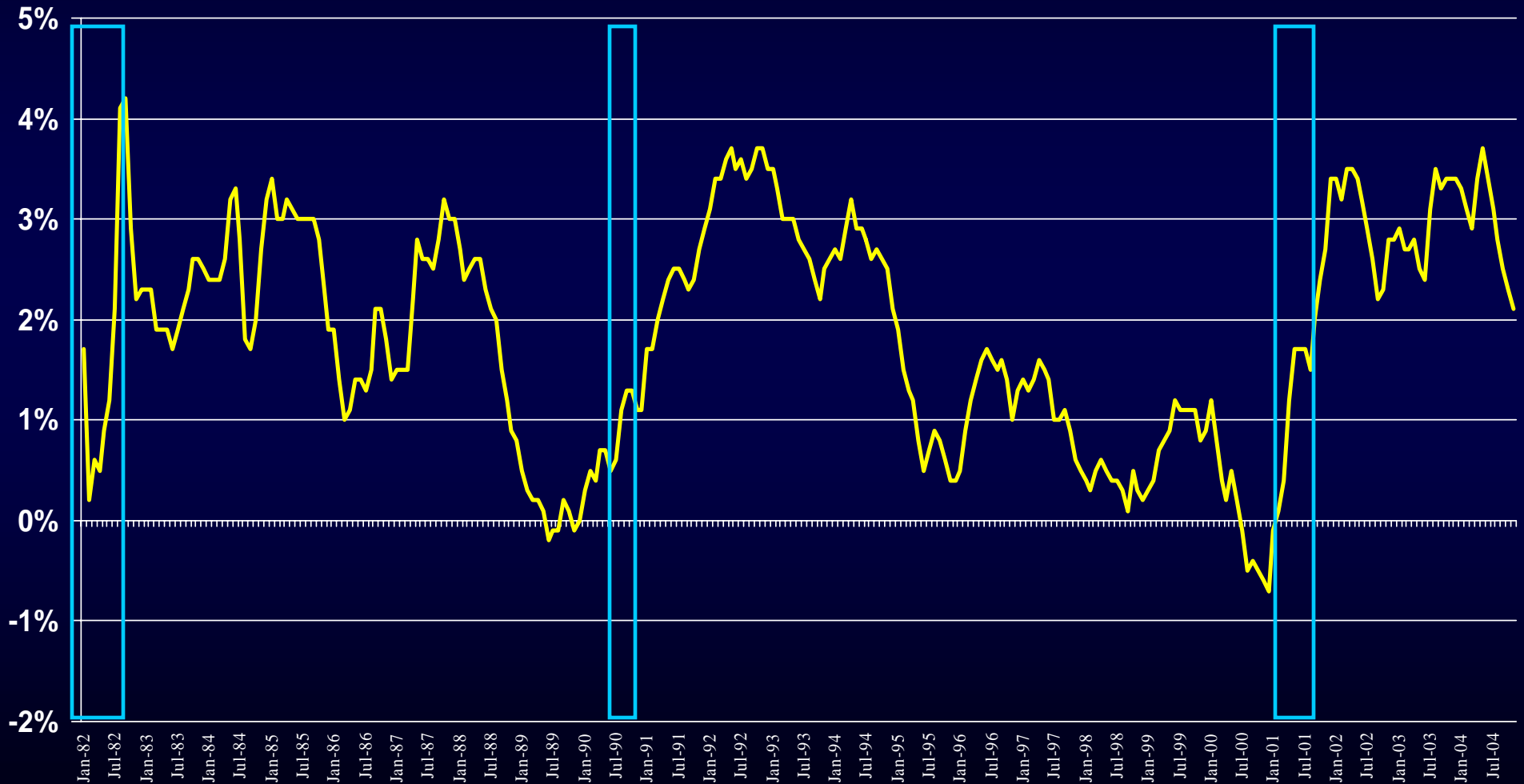


•Data through October 2004.

 Recession Periods

10-Year Treasury Rate minus 3-month Treasury Rate 1976 – 2004*

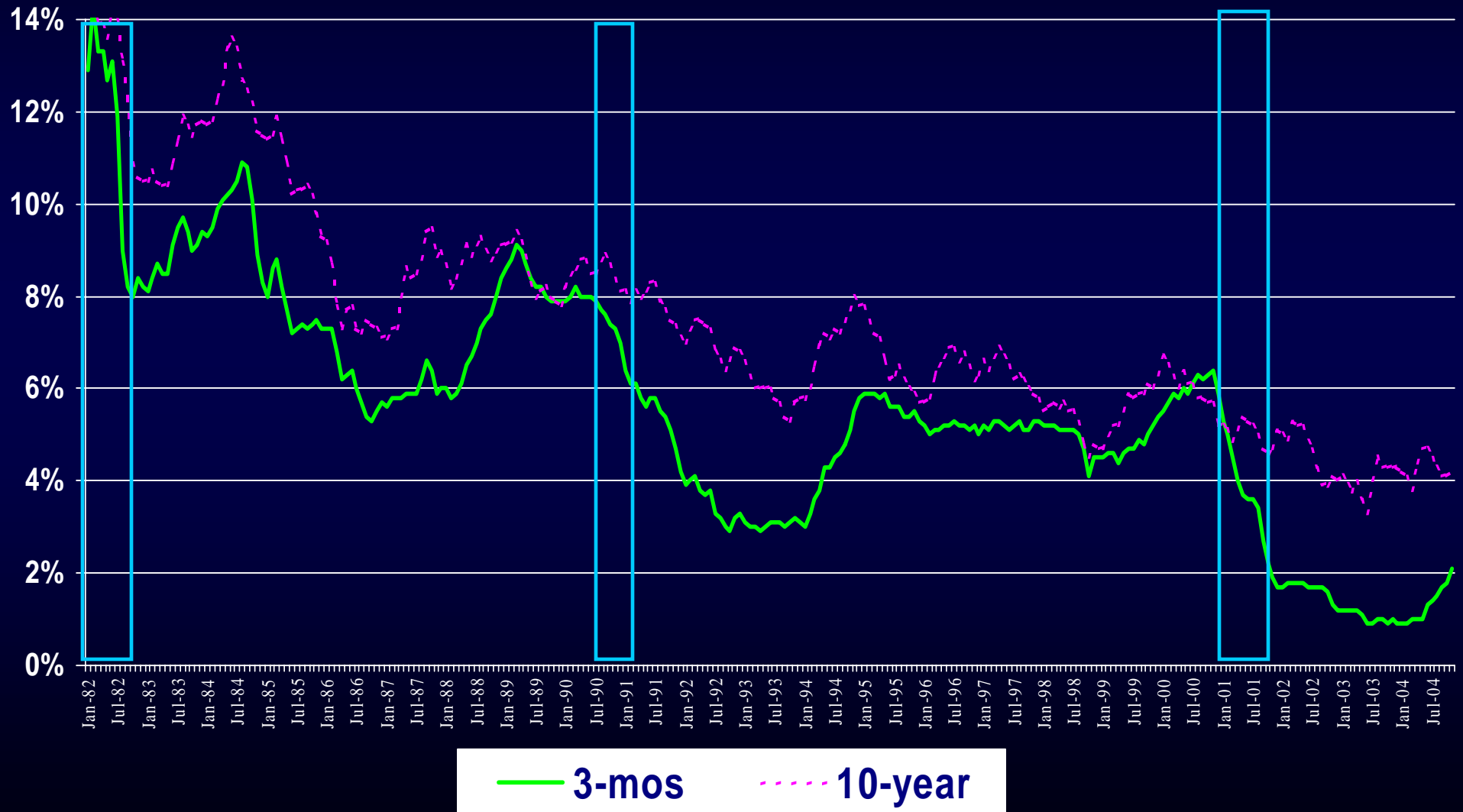
Source: Federal Reserve Economic Database



•Data through November 2004.

10-Year Treasury Rate v. 3-month Treasury Rate 1976 – 2004*

Source: Federal Reserve Economic Database



•Data through November 2004.

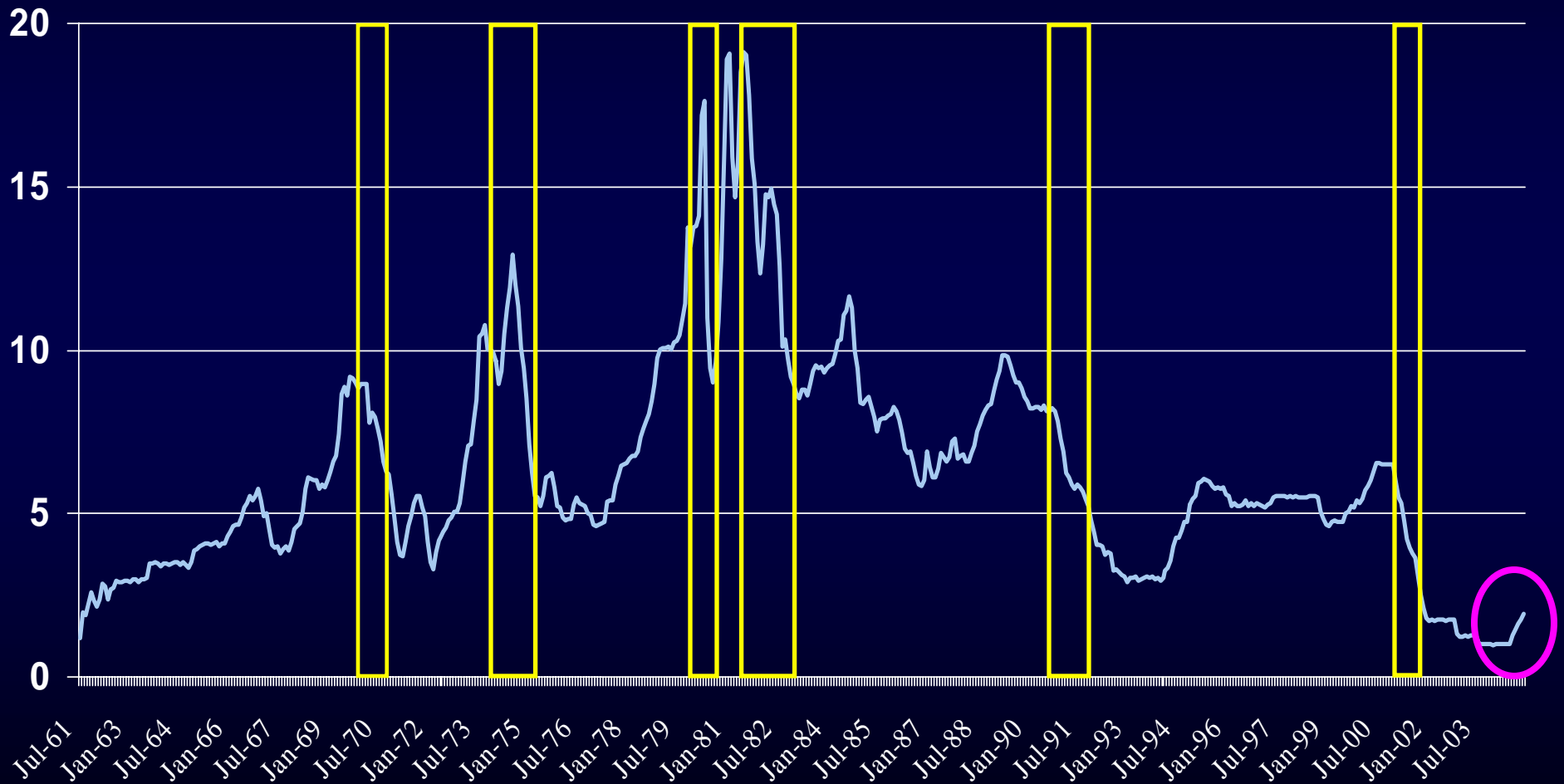
Government



**Lots
of
Stimulus**

Federal Funds Rate 1961 – 2004*

Source: Federal Reserve

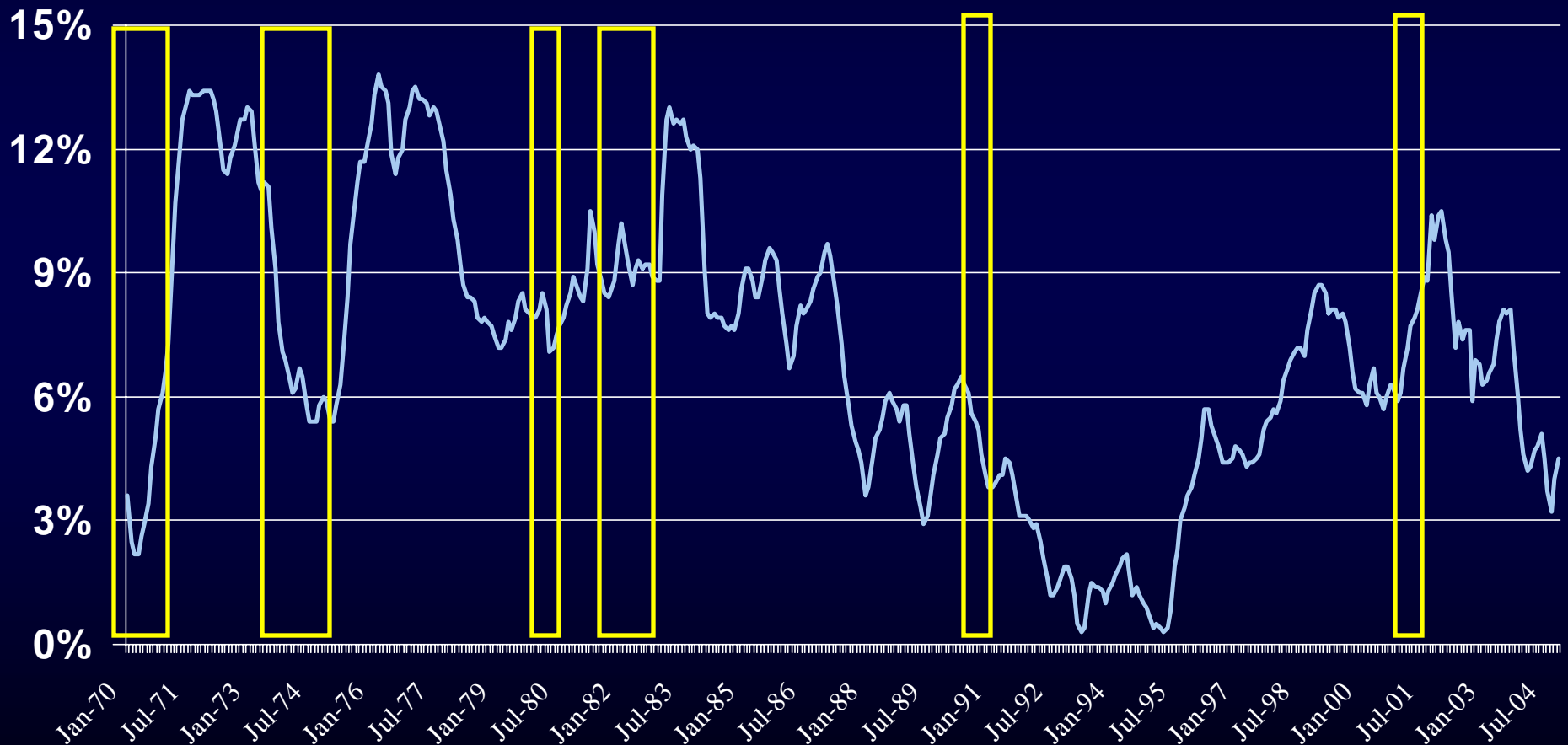


•Data through November 2004.

Recession Periods

M2 Stock – Seasonally Adjusted Percent Change Year Ago 1970 – 2004*

Source: Federal Reserve Bank of St. Louis, U.S. Bureau of Labor Statistics



* Data through October 2004.

 Recession Periods

Fiscal Stimulus

- **\$140 billion in 2004**

Including: \$47 billion marginal tax rate

\$36 billion marriage-penalty relief

\$16 billion childcare credit

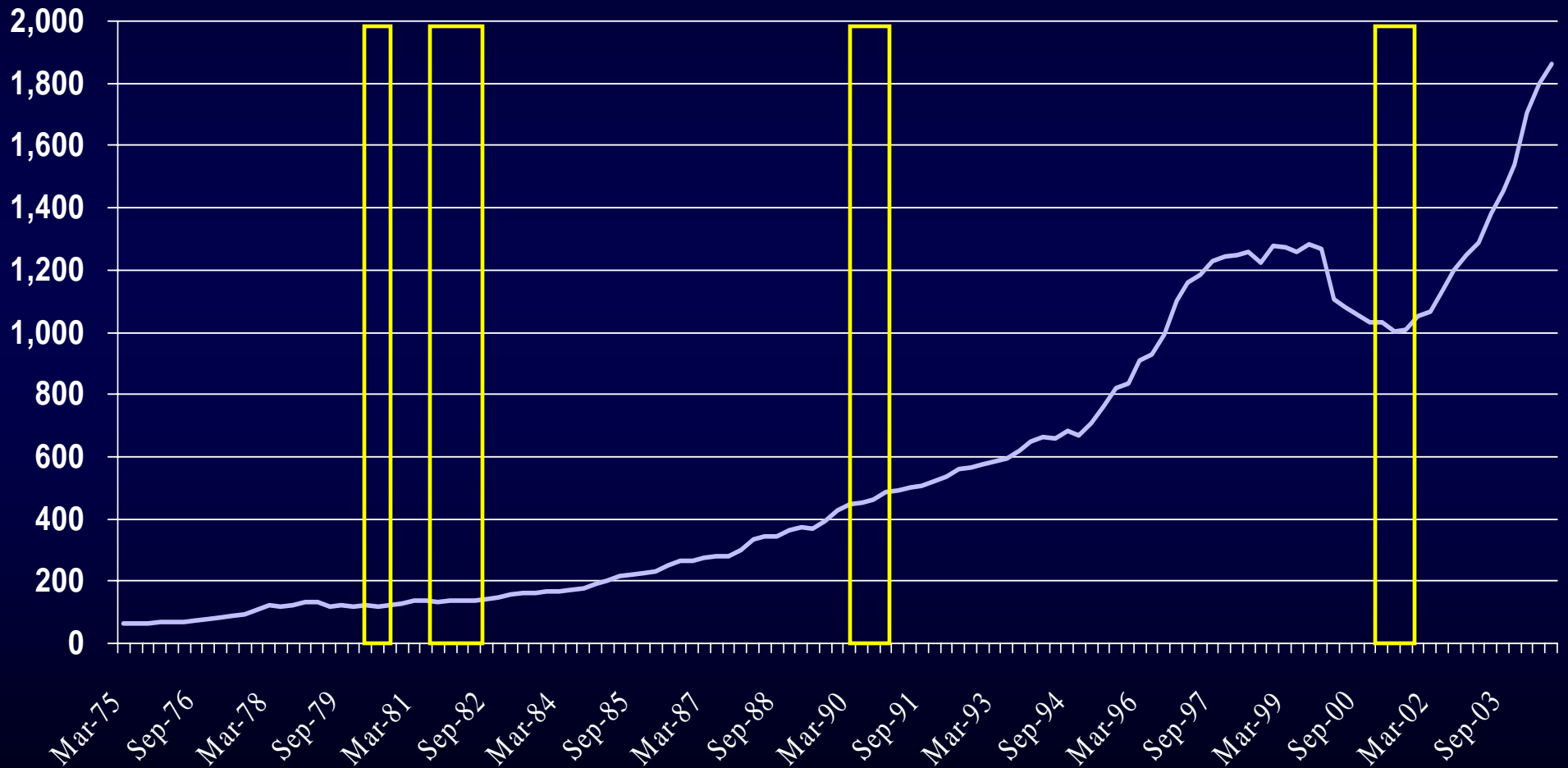


Deficit ?

U.S. Debt Held by Foreign & International Investors 1975-2004*

(Billions of Dollars, SA)

Source: Federal Reserve Economic Database



•Data through third quarter 2004.

2005

**Good times
ahead?**

Mostly.

U.S. OUTLOOK **GOOD** NEWS

- **Fiscal stimulus**
- **Monetary stimulus**
- **Real incomes up**
- **Businesses mean and lean**
- **Productivity growth strong**
- **Job growth accelerating, albeit slowly**
- **Cheaper dollar means more exports**
- **Inflation (in near term) not a problem**
- **Tech changes will shortly be upon us**
- **Low interest rates**

**U.S. Outlook
NET:**

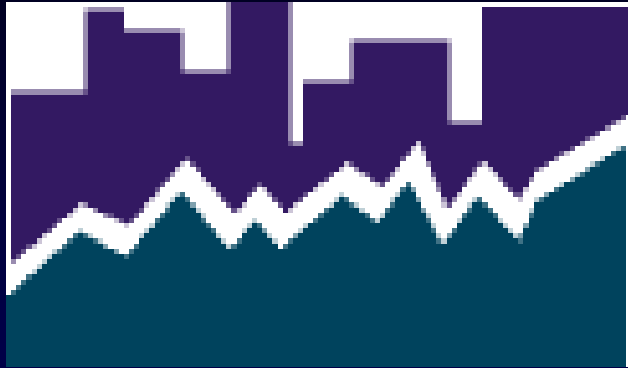
**Economy will
continue to expand.**

Keys To Sustained Economic Upturn

- Policy Works
- Business Investment
- Job Growth
- Consumer Confidence
- Stock Market
- No External Shocks



Greenspan Prays For Job Growth



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